

# EXHIBIT B

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-K**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2005

Commission File Number 0-22999

**Tarragon Corporation**

(Exact name of registrant as specified in its charter)

Nevada	94-2432628
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1775 Broadway, 23rd Floor, New York, NY	10019
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code (212) 949-5000

Securities registered pursuant to Section 12 (b) of the Act: None

Securities registered pursuant to Section 12 (g) of the Act:

Common Stock, \$.01 par value

(Title of class)

10% Cumulative Preferred Stock, \$.01 par value

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes

No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes

No

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13

Table of Contents**ITEM 1A. RISK FACTORS****Risks Related to Tarragon****Risks Related to Our Capital Structure**

***Our substantial indebtedness and high leverage could adversely affect our financial health and prevent us from fulfilling our obligations.***

We have substantial indebtedness and debt service requirements. As of December 31, 2005:

- our total consolidated indebtedness was \$953 million; and
- our total indebtedness in unconsolidated partnerships and joint ventures was \$532 million.

Our high degree of leverage could have important consequences, including the following:

- a substantial portion of our cash flow from operations is dedicated to the payment of principal and interest on our indebtedness, thereby reducing the funds available to us for other purposes;
- our ability to obtain additional financing for working capital, capital expenditures, acquisitions, or general corporate or other purposes may be impaired in the future;
- certain of our borrowings are and will continue to be at variable rates of interest, which will expose us to the risk of increased interest rates; and
- it may limit our flexibility to adjust to changing economic or market conditions, reduce our ability to withstand competitive pressures and make us more vulnerable to a downturn in general economic conditions.

Our secured credit facilities and the other agreements governing our indebtedness limit, but do not prohibit, us or our subsidiaries from incurring significant additional indebtedness in the future. Therefore, these risks may increase as we incur additional indebtedness.

***We may not be able to generate sufficient cash flow to meet our debt service obligations.***

Our ability to make scheduled payments of principal or interest on our indebtedness will depend on our future performance, which, to a certain extent, is subject to general economic conditions, financial, competitive, legislative, regulatory, political, business, and other factors. We believe that cash generated by our business will be sufficient to enable us to make our debt payments as they become due. However, if our business does not generate sufficient cash flow, or future borrowings are not available in an amount sufficient to enable us to service our indebtedness or to fund our other liquidity needs, we may not be able to fulfill our debt service obligations.

***The restrictive covenants associated with our outstanding indebtedness may limit our ability to operate our business.***

Our existing indebtedness contains various covenants that may limit or restrict the creation of liens, mergers, consolidations, dispositions of assets, dividends, redemptions of capital stock, changes in our business or accounting practices, transactions with affiliates, and certain other transactions or business activities. In

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addition, a number of our debt agreements contain covenants that require us to maintain financial ratios. If we fail to comply with these covenants, we may be in default, and that existing indebtedness can be accelerated so it becomes immediately due and payable.

***The market price for our common stock may be highly volatile.***

The market price for our common stock may be highly volatile. A variety of factors may have a significant impact on the market price of our common stock, including:

- our financial condition, results of operations, and prospects;
- the publication of earnings estimates or other research reports and speculation in the press or investment community;
- changes in our industry and competitors;
- any future issuances of our common stock, which may include primary offerings for cash, issuances in connection with business acquisitions, and the grant or exercise of stock options from time to time;
- general market and economic conditions; and
- any outbreak or escalation of hostilities.

In addition, the NASDAQ National Market can experience significant price and volume fluctuations that can be unrelated or disproportionate to the operating performance of the companies listed on NASDAQ. Broad market and industry factors may negatively affect the market price of our common stock regardless of our operating performance. In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been instituted. This type of litigation, if instituted, could result in substantial costs and a diversion of management's attention and resources, which could harm our business.

***Shares of our common stock eligible for public sale could adversely affect the market price of our common stock.***

The market price of our common stock could decline as a result of sales or other issuances of a large number of shares in the market or market perception that these transactions could occur, including sales or distributions of shares by one or more of our large stockholders or by our controlling stockholders. As of December 31, 2005, there were 28,567,364 shares of our common stock outstanding. Of those shares, 12,146,550 were held by our controlling stockholders, Mr. and Mrs. William S. Friedman and their affiliated entities, and a further 1,021,961 were held by our other executive officers and directors.

***We have a substantial number of stock options and other interests convertible into our common stock outstanding and have the ability to grant a substantial number of stock options in the future under currently effective benefit plans.***

As of December 31, 2005, we had outstanding options to purchase approximately 2.7 million shares of our common stock and share appreciation rights covering an additional 97,152 shares under our equity participation plans to our directors, officers, key employees, and consultants and had approximately 1.7 million shares available for future grant. Additionally, at December 31, 2005, Robert C. Rohdie's minority interest in Tarragon Development Company, LLC, is convertible into 668,096 shares of our common stock, and our senior convertible notes are convertible into 469,771 shares of our common stock. The exercise of outstanding options

Table of Contents**Consolidated Results of Operations****2005 Compared to 2004**

Total consolidated revenue in 2005 was \$571.9 million, or twice the amount for the prior year. Substantially all the increase was attributable to greater homebuilding sales. We expect homebuilding sales revenue to continue to increase as more communities under development and in our pipeline, especially in the Northeast, begin to generate revenue. See the tables that summarize homebuilding sales and present our active projects, including backlog of homes sold, not closed, and our development pipeline below under the caption "Homebuilding Division."

Rental revenue increased \$4.9 million, or 8%, for the year ended December 31, 2005, compared to the same period in 2004. This increase is attributable to two apartment communities acquired in February 2005 and one apartment community acquired in May 2004. These three properties along with eight other consolidated properties were contributed to an unconsolidated partnership in November 2005 and will no longer be reported in our consolidated revenue. Rental revenue for these eleven properties in 2005 was \$26.2 million.

Income from continuing operations increased more than three-fold to \$102.3 million in 2005 compared to \$33.3 million in 2004. Gross profit from homebuilding sales contributed \$64.5 million of this increase. Equity in income of partnerships and joint ventures increased \$75.8 million, of which \$60 million was income from distributions in excess of investment in Ansonia in connection with its November 2005 financing of 23 properties and the remainder resulted from our share of gross profit from homebuilding sales of unconsolidated partnerships and joint ventures. These increases were partially offset by higher income tax expense: \$62.8 million in 2005 compared to \$7.4 million in 2004. Additionally, in 2005, we incurred costs of \$7.2 million associated with the conversion of \$54.25 million of senior convertible notes into 4,432,181 shares of our common stock and \$9.4 million in connection with the early repayment of a participating loan.

During 2005, we recognized gains on sale of real estate of \$71.1 million (net of income taxes of \$25.6 million), including those presented in discontinued operations in accordance with SFAS No. 144. In 2004, we recognized \$18.4 million in gains on sale of real estate, (net of income taxes of \$7.1 million) including those presented in discontinued operations. See "Sales of Consolidated Properties" below.

*Operating Results of Consolidated Rental Properties.* At December 31, 2005, our consolidated rental properties presented in continuing operations included rental communities with 1,785 apartments (excluding 948 units in assets held for sale and presented in discontinued operations) and one commercial property with 102,000 square feet (excluding 782,000 square feet in assets held for sale and presented in discontinued operations). The following table summarizes aggregate property level revenue and expenses for our consolidated rental properties presented in continuing operations for the years ended December 31, 2005 and 2004. The revenue and expenses below exclude management fee and other revenue and interest expense on corporate debt.

	For the Years Ended December 31,		
	2005	2004	Change
Rental revenue	\$ 66,483	\$ 61,573	\$ 4,910
Property operating expenses	(33,904)	(32,301)	(1,603)
Interest expense	(12,686)	(16,706)	4,020
Depreciation expense	(11,033)	(14,307)	3,274
	<u>\$ 8,860</u>	<u>\$ (1,741)</u>	<u>\$10,601</u>

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The following table illustrates the impact on the change between 2004 and 2005 resulting from properties targeted for conversion to condominium homes for sale on the revenues and expenses of our consolidated rental properties:

	Condominium Conversions	Other Changes	Total
Rental revenue	\$ (45)	\$ 4,955 (2)	\$ 4,910
Property operating expenses	412	(2,015)(2)	(1,603)
Interest expense	2,849	1,171 (1)	4,020
Depreciation expense	2,134	1,140 (2)	3,274
	<u>\$ 5,350</u>	<u>\$ 5,251</u>	<u>\$10,601</u>

(1) Increase is primarily due to increase in interest rates on variable rate debt.

(2) Increase is primarily due to the acquisition of two properties in 2005 and one property in 2004.

*Equity in Income of Unconsolidated Partnerships and Joint Ventures.* The following table summarizes the components of equity in income of unconsolidated partnerships and joint ventures for 2005 and 2004:

	For the Years Ended December 31,		
	2005	2004	Change
<i>Homebuilding operations</i>			
Homebuilding sales revenue	\$ 230,806	\$ 95,031	\$135,775
Costs of homebuilding sales	(160,859)	(65,681)	(95,178)
Gross profit from homebuilding sales	<u>69,947</u>	<u>29,350</u>	<u>40,597</u>
<i>Rental property operations</i>			
Rental revenue	36,154	35,864	290
Property and other operating expenses	(17,752)	(17,212)	(540)
Interest expense (including \$16,954 of prepayment penalties and the write-off of deferred borrowing costs in connection with Ansonia's November 2005 refinancing of 23 properties)	(30,504)	(12,630)	(17,874)
Depreciation expense	(6,018)	(6,096)	78
Mortgage banking income	916	—	916
Discontinued operations	(613)	1,732	(2,345)
Elimination of management and other fees paid to Tarragon	1,672	1,456	216
Outside partners' interests in income of joint ventures	(33,014)	(15,588)	(17,426)
Overhead costs associated with investments in joint ventures	(1,404)	—	(1,404)
Performance-based compensation related to homebuilding projects of unconsolidated partnerships and joint ventures	(2,757)	—	(2,757)
Distributions in excess of investment	64,866	5,816	59,050
Loss in excess of investment unrecognized	15,452	—	15,452
Impairment (loss) recovery	350	(1,162)	1,512
Equity in income of partnerships and joint ventures	<u>\$ 97,295</u>	<u>\$ 21,530</u>	<u>\$ 75,765</u>

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Gross profit from homebuilding sales was generated by The Grande and The Hamptons, two condominium conversion projects acquired in 2004 by unconsolidated joint ventures, and XII Hundred Grand and XIII Hundred Grand, two of our Hoboken, New Jersey, projects. See the table below in "Homebuilding Division" for revenue and gross profit reported by each of these projects.

Discontinued operations include the operations and gain or loss on sale of Prospect Park, the only property of the Sacramento Nine joint venture, which was sold in December 2004, and Arbor Glen, the sole property of Larchmont Associates, which was sold in January 2005. In the fourth quarter of 2004, we recorded a \$1.2 million impairment charge to write down the carrying value of our investment in Larchmont, which included \$1.3 million of advances made during 2004, to our share of the estimated net sale proceeds. In 2005, we recovered \$350,000 of this impairment loss upon the closing of the sale.

When we compute equity in income of partnerships and joint ventures, we eliminate intercompany items, including management fees the joint ventures pay us and interest on advances we have made to joint ventures.

The increase in outside partners' share of income of joint ventures is primarily attributable to our partners' share of the gross profit reported by The Grande, The Hamptons, XII Hundred Grand, and XIII Hundred Grand.

Distributions in excess of investment are primarily related to the distribution of financing proceeds of Ansonia, in which we have recovered our investment, in connection with its November 2005 financing of 23 properties.

Loss in excess of investment unrecognized is related to Ansonia. In accordance with the Accounting Principles Board's Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock," we have discontinued recording our share of Ansonia's losses (caused by prepayment penalties associated with its November 2005 refinancing of 23 properties) because our investment balance is zero and we have not guaranteed Ansonia's obligations.

In addition, our equity in income of unconsolidated partnerships and joint ventures was affected during the periods presented above by:

- the consolidation of one property in September 2004 and one property in November 2005; and
- the deconsolidation of 11 apartment communities contributed to Ansonia in November 2005.

The following table presents the effect of these items on the unconsolidated entities' property level revenue and expenses for 2005 and 2004:

	Properties Consolidated in 2004 and 2005 (1)	Properties Deconsolidated in 2005 (2)	Other Changes	Total
Rental revenue	\$ (2,739)	\$2,445	\$ 584	\$ 290
Property and other operating expenses	(1,360)	1,466	(646)	(540)
Interest expense	(779)	3,762	(20,857)(3)	(17,874)
Depreciation expense	(619)	545	152	78
	<u>\$ (5,497)</u>	<u>\$8,218</u>	<u>\$(20,767)</u>	<u>\$(18,046)</u>

(1) Merritt 8 and Vineyard at Eagle Harbor were consolidated in September 2004 and November 2005, respectively, due to buyout of our partners' interests.

(2) Eleven apartment communities were deconsolidated in November 2005 after being contributed to Ansonia.

- (3) The increase in interest expense resulted from prepayment penalties and the write off of deferred borrowing costs in connection with the refinancing of 23 properties.

*Provision for Estimated Losses.* We recorded a \$1.6 million reserve in the third quarter of 2005 for the full amount of a note receivable in connection with the 2002 sale of English Village Apartments in Memphis,



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Tennessee, when the borrower, a non-profit affordable housing developer, notified us he would no longer be making payments under the terms of the note.

*General and Administrative Expenses.* Corporate general and administrative expenses increased \$4.6 million, or 28%, for 2005 compared to 2004 primarily due to investment banking advisory fees of \$2.4 million in 2005 related to the Investment Division properties disposition strategy and fees of \$643,000 related to the conversion of convertible notes to common stock in the third quarter of 2005. We wrote off \$1.4 million in pursuit costs for projects that we abandoned.

Property general and administrative expenses increased by \$713,000, or 16%, for 2005 compared to 2004, primarily due to property management personnel additions and compensation increases. Our property management team oversees the Investment Division properties and the initial lease-up of newly constructed rental apartment communities and provides property management services to rental apartment communities under conversion to condominiums.

*Corporate Interest.* Corporate interest increased \$2.6 million in 2005 compared to 2004. In 2005, interest expense on our senior convertible notes, issued in 2004, increased \$9.4 million. This interest included the premium paid and the write off of deferred financing expenses totaling \$7.2 million upon the conversion of \$54.25 million of the convertible notes to common stock in the third quarter of 2005. Interest expense on \$65 million of unsecured subordinated notes issued in 2005 resulted in an increase of \$2.6 million. These increases are partially offset by a decrease of \$9.9 million resulting from interest capitalized on development projects.

**2004 Compared to 2003**

For the year ended December 31, 2004, total consolidated revenue was \$282.9 million, compared to \$105.2 million in 2003. This increase is mostly attributable to the increase in homebuilding sales. The consolidation of Las Olas River House in January 2004 resulted in a \$51.9 million increase in consolidated homebuilding sales revenue in 2004. In 2003, Las Olas River House was unconsolidated and reported \$97.6 million in homebuilding sales revenue.

Rental revenue increased \$13.6 million, or 28.3%, for the year ended December 31, 2004, as compared to the same period of 2003. As presented below under "Operating Results of Consolidated Rental Properties," four rental apartment communities consolidated in January 2004 as a result of our adoption of the provisions of FIN 46R contributed an increase of \$12.2 million of this increase. Rental apartment communities in lease-up during one or both periods presented contributed a \$1.9 million to the increase in rental revenue.

Income from continuing operations was \$33.3 million for the year ended December 31, 2004, compared to \$8.5 million for the year ended December 31, 2003. Gross profit from homebuilding sales increased \$35.3 million. Equity in income of partnerships and joint ventures decreased \$946,000 chiefly due to \$16.3 million recognized in 2003 as our share of the gross profit on home sales of Las Olas River House which was consolidated in January 2004 as a result of our adoption of the provisions of FIN 46R. This decrease was partially offset by our share of gross profit totaling \$12.8 million recognized in 2004 on home sales of XII Hundred Grand and XIII Hundred Grand.

During the year ended December 31, 2004, we recognized gains on sale of real estate totaling \$18.4 million, including those presented in discontinued operations in accordance with SFAS No. 144. During 2003, gains on sale, including those presented in discontinued operations, were \$24.3 million. During 2004, we also sold our interest in Ninth Street Development, which had development rights for land in Hoboken, New Jersey, for \$2.2 million and recognized a gain of \$1.7 million. See "Sales of Consolidated Properties."

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consolidated commercial properties in 2003. These sales brought decreases in net operating income of \$6.6 million in 2005 compared to 2004 and \$375,000 in 2004 compared to 2003. The Investment Division's gains on sale of real estate have been reduced by \$4.9 million in 2005 and \$5.8 million in 2003 for additional costs reported by the Investment Division resulting from intercompany profit recognized previously by the Homebuilding Division upon the transfer of stabilized rental properties to the Investment Division. The Investment Division reported gains on intercompany sales of \$2.9 million in 2003. These intercompany sales related to the transfer of properties to the Homebuilding Division for renovation or conversion to condominiums. Since January 2004, we transfer properties between segments at cost.

Interest expense for the Investment Division increased by \$18.1 million, or 45.6%, in 2005 compared to 2004. For the 34 same store stabilized apartment communities, interest expense almost doubled from \$20.6 million to \$39.6 million in 2005 compared to 2004. The increase in 2005 is chiefly due to prepayment penalties and the write-off of deferred financing costs in connection with Ansonia's refinancing of 23 properties in November 2005.

Investment Division interest expense increased by 9.2% to \$39.8 million in 2004 from \$36.4 million in 2003. The 34 same store stabilized apartment communities reported a \$628,000, or 3.2%, increase. A \$2.4 million increase was the result of properties targeted for condominium conversion in 2005.

Investment Division depreciation expense was \$18.9 million in 2005, \$31.1 million in 2004, and \$29.9 million in 2003. In 2005, a decrease of \$11.8 million was related to ceasing depreciation upon the reclassification of properties to held for sale and on properties targeted for condominium conversion.

General and administrative expenses of the Investment Division increased to \$9.9 million in 2005 from \$6.4 million in 2004 and \$5.4 million in 2003. General and administrative expenses were 8.6% of divisional revenues in 2005, 4.7% in 2004, and 4.4% in 2003. The increase in 2005 is principally due to investment banking advisory fees of \$2 million in connection with the Investment Division properties disposition plan.

**Liquidity and Capital Resources****Liquidity**

Our principal sources of cash are home sales, rental operations of Investment Division properties, borrowings, and proceeds from the sale of Investment Division properties. As our Homebuilding Division continues to grow, home sales, along with project-related construction loans or general corporate borrowings, will become our primary source of cash. We believe these sources will continue to meet our cash requirements, including debt service, property maintenance and improvements, acquisitions of land for development, development costs for rental apartment and for-sale communities under construction or renovation, projected purchases of existing properties, dividends on preferred stock, and repurchases of common stock under the announced stock repurchase program. Although we expect these sources of cash to be sufficient to fund planned uses of cash, we can make no assurance that the expected home sales and Investment Division property sales and borrowings will be completed as planned.

**Mortgages and Other Debt**

*Senior Convertible Notes.* On July 1, 2005, we converted \$2 million of our senior convertible notes into 163,399 shares of common stock after presentment for conversion by a noteholder. On August 23, 2005, we converted \$54.25 million of these notes pursuant to an offer made to the holders. Each holder who accepted the offer received 81.6993 shares of Tarragon common stock and \$80 in cash for each \$1,000 principal amount of convertible notes tendered plus accrued and unpaid interest. In connection with the offer, we issued 4,432,181

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shares of Tarragon common stock and paid approximately \$6.2 million in premium and accrued interest. The outstanding principal balance of our convertible notes was \$5.75 million at December 31, 2005.

*Unsecured Subordinated Notes.* On June 15, 2005, we issued \$40 million of unsecured subordinated notes due June 30, 2035. The notes bear interest, payable quarterly, at a rate of 8.71% through June 30, 2010, and thereafter at a variable rate equal to LIBOR plus 4.4% per annum. The notes are prepayable after June 30, 2010, at par. On September 12, 2005, we issued an additional \$25 million of unsecured subordinated notes due October 30, 2035. These notes bear interest, payable quarterly, at a rate of 8.79% through October 30, 2010, and thereafter at a variable rate equal to LIBOR plus 4.4% per annum. The notes are prepayable after October 30, 2010, at par. As of December 31, 2005, the outstanding principal balance of these two series of unsecured subordinated notes was \$65 million.

*Unsecured Credit Facilities.* At December 31, 2005 we had a \$20 million unsecured line of credit with affiliates of William S. Friedman, our chief executive officer and chairman of our Board of Directors, with no outstanding balance. Effective in January 2006, this line of credit was increased to \$30 million and its term renewed and extended until January 2008. Advances under this line of credit bear interest at the lower of 100 basis points over the thirty-day LIBOR or the lowest rate offered in writing to us for an unsecured loan by an institutional lender. Payments of interest only are due on demand but no more frequently than monthly, with all outstanding principal and interest due at maturity.

We have a \$10 million unsecured line of credit with Bank of America. Advances under the line of credit bear interest at 200 basis points over 30 day LIBOR. Payments of interest only are due monthly, with all outstanding principal and interest due at maturity of October 2006. As of December 31, 2005, \$3 million was available to us under this line of credit.

*Secured Credit Facilities.* Until its January 2006 maturity, we had an \$18.3 million revolving line of credit with Wachovia Bank. Payment terms were interest only monthly at a floating rate equal to the 30-day LIBOR plus 175 basis points, with the outstanding principal amount due at maturity. It was secured by four properties and shares of our common stock owned by Mr. Friedman and his affiliates. We have agreed to indemnify Mr. Friedman and his affiliates from any loss, cost, or liability associated with their pledge of stock to secure this line of credit. As of December 31, 2005, \$12.4 million was available to us under this line of credit.

We currently have mortgage loans totaling \$84.2 million (of which \$25 million represents a revolving commitment), secured by a pool of three properties under a secured credit facility with General Electric Capital Corporation ("GECC") that matures in May 2008. The mortgage loans under this facility are cross-collateralized and cross-defaulted. Under the GECC mortgage facility, we are required to maintain, at all times, a consolidated net worth of not less than \$50 million, measured at the end of each quarter, and minimum aggregate unrestricted cash and marketable securities of not less than \$10 million in order to be able to incur other debt. Two of these properties with an aggregate balance of \$37.3 million bear interest at 173 basis points over 30-day LIBOR, payable monthly. One property has a loan with a balance of \$46.9 million that currently bears interest at 190 basis points over the 30-day LIBOR and requires monthly payments of principal and interest computed on a 27 $\frac{1}{2}$ -year amortization schedule. We have an option to extend this credit facility for one year, which requires a ratio of net operating income to total debt of 10% or greater and a debt service coverage ratio of 1.25x or greater.

*Non-recourse Mortgage Debt.* In addition to the GECC mortgage facility, as of December 31, 2005, we had an aggregate of \$131.3 million of outstanding non-recourse indebtedness secured by 15 Investment Division assets (of which five are classified as held for sale at December 31, 2005) and five Homebuilding Division properties targeted for conversion to condominiums. The agreements governing this mortgage debt generally do not contain restrictive covenants and are not guaranteed by us or any of our subsidiaries or joint ventures. Of these

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All other schedules are omitted because they are not required or are not applicable or because the information required is included in the Consolidated Financial Statements or Notes.

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and  
Stockholders of Tarragon Corporation

We have audited the accompanying consolidated balance sheets of Tarragon Corporation and subsidiaries (collectively, the "Company") as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Tarragon Corporation and subsidiaries, as of December 31, 2005 and 2004, and the consolidated results of their operations and their consolidated cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, the Company adopted Financial Accounting Standards Board Interpretation 46-R "Consolidation of Variable Interest Entities" in 2004.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Tarragon Corporation and subsidiaries' internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 15, 2006, expressed an unqualified opinion on management's assessment of, and an unqualified opinion on the effective operation of, internal control over financial reporting.

/s/ GRANT THORNTON LLP

Dallas, Texas  
March 15, 2006

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CONSOLIDATED BALANCE SHEETS

	December 31,	
	2005	2004
	(dollars in thousands)	
Assets		
Homebuilding inventory:		
Land and land improvement costs	\$ 259,287	\$ 99,353
Construction in progress	795,781	188,000
Real estate held for investment (net of accumulated depreciation of \$21,392 in 2005 and \$128,375 in 2004)	122,165	489,215
Contracts receivable	49,745	99,744
Assets held for sale	63,521	21,870
Investments in and advances to partnerships and joint ventures	79,173	48,074
Cash and cash equivalents	38,627	22,066
Restricted cash	21,830	30,210
Other assets, net	65,415	49,759
	<u>\$1,495,544</u>	<u>\$1,048,291</u>
Liabilities and Stockholders' Equity		
Liabilities		
Notes and interest payable:		
Loans on homebuilding developments	\$ 760,152	\$ 217,674
Mortgages on real estate	58,969	478,135
Subordinated unsecured notes	65,000	—
Senior convertible notes	5,750	62,000
Other notes payable	11,144	8,400
Accrued interest	5,312	4,038
Liabilities related to assets held for sale	54,671	20,664
Deferred tax liability	71,793	12,720
Other liabilities	97,852	71,217
	<u>1,130,643</u>	<u>874,848</u>
Commitments and contingencies		
Minority interest	14,403	21,760
Stockholders' equity		
Common stock, \$.01 par value; authorized shares, 100,000,000; shares issued, 37,937,860 in 2005 and 21,179,479 in 2004	379	212
Special stock, \$.01 par value; authorized shares, 17,500,000; no shares outstanding	—	—
Cumulative preferred stock, \$.01 par value; authorized shares, 2,500,000; shares outstanding, 748,833 in 2005 and 753,333 in 2004; liquidation preference, \$8,986 in 2005 and \$9,040 in 2004, or \$12 per share	7	8
Paid-in capital	402,531	336,846
Accumulated deficit	(13,661)	(158,553)

Treasury stock, at cost (9,370,496 shares in 2005 and 5,856,587 shares in 2004)

<u>(38,758)</u>	<u>(26,830)</u>
<u>350,498</u>	<u>151,683</u>
<u>\$1,495,544</u>	<u>\$1,048,291</u>

The accompanying notes are an integral part of these Consolidated Financial Statements.

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TARRAGON CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME

	For the Years Ended December 31,		
	2005	2004	2003
	(dollars in thousands, except per share data)		
Revenue			
Homebuilding sales	\$504,722	\$220,465	\$ 56,279
Rental and other	67,212	62,399	48,907
	<u>571,934</u>	<u>282,864</u>	<u>105,186</u>
Expenses			
Cost of homebuilding sales	394,999	175,279	46,431
Property operations	33,904	32,301	26,168
Depreciation	11,033	14,307	12,065
Provision for estimated losses	1,628	—	—
Impairment charges	—	733	—
General and administrative			
Corporate	21,015	16,407	13,234
Property	5,072	4,359	3,692
	<u>467,651</u>	<u>243,386</u>	<u>101,590</u>
Other income and expenses			
Equity in income of partnerships and joint ventures	97,295	21,530	22,476
Minority interests in income of consolidated partnerships and joint ventures	(2,564)	(3,818)	(2,590)
Interest income (including \$242 in 2005, \$332 in 2004, and \$678 in 2003 from affiliates)	995	728	1,605
Interest expense (including \$49 in 2005, \$12 in 2004, and \$2 in 2003 to affiliates)	(27,801)	(19,373)	(17,883)
Gain on sale of real estate	3,808	378	1,223
Gain (loss) on disposition of other assets	(300)	2,075	—
Loss on early extinguishment of debt	(9,354)	—	—
Litigation, settlements, and other claims	(1,214)	(250)	60
Income from continuing operations before income taxes	165,148	40,748	8,487
Income tax expense	(62,839)	(7,400)	—
Income from continuing operations	102,309	33,348	8,487
Discontinued operations, net of income taxes (\$26.7 million in 2005, \$7.6 million in 2004, and none in 2003)			
Income (loss) from operations	1,773	410	(411)
Gain on sale of real estate	41,709	10,950	23,118
Net income	145,791	44,708	31,194
Dividends on cumulative preferred stock	(899)	(904)	(785)
Net income allocable to common stockholders	<u>\$144,892</u>	<u>\$ 43,804</u>	<u>\$ 30,409</u>

The accompanying notes are an integral part of these Consolidated Financial Statements.



Table of ContentsTARRAGON CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME (Continued)

	For the Years Ended December 31,		
	2005	2004	2003
(dollars in thousands, except per share data)			
Earnings per common share — basic			
Income from continuing operations allocable to common stockholders	\$ 3.93	\$ 1.44	\$ .35
Discontinued operations	<u>1.68</u>	<u>.50</u>	<u>1.03</u>
Net income allocable to common stockholders	<u>\$ 5.61</u>	<u>\$ 1.94</u>	<u>\$ 1.38</u>
Earnings per common share — assuming dilution			
Income from continuing operations allocable to common stockholders	\$ 3.36	\$ 1.23	\$ .31
Discontinued operations	<u>1.35</u>	<u>.42</u>	<u>.89</u>
Net income allocable to common stockholders	<u>\$ 4.71</u>	<u>\$ 1.65</u>	<u>\$ 1.20</u>

The accompanying notes are an integral part of these Consolidated Financial Statements.

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TARRAGON CORPORATION  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Preferred Stock		Common Stock		Paid-in Capital	Accumulated Deficit	Treasury Stock Amount	Stockholders' Equity
	Shares	Amount	Shares	Amount	(dollars in thousands)			
Balance, January 1, 2003	560,518	\$ 6	7,896,760	\$ 116	\$337,547	\$ (232,766)	\$(31,170)	\$ 73,733
Repurchase of common stock	—	—	(275,443)	—	—	—	(4,151)	(4,151)
Retirement of preferred stock	(3,000)	—	—	—	(35)	—	—	(35)
Retirement of treasury stock	—	—	—	(9)	(8,045)	—	8,054	—
Stock options exercised	—	—	38,644	—	246	—	—	246
Three-for-two common stock split	—	—	3,924,012	58	(58)	—	—	—
Dividends on cumulative preferred stock (\$1.20 per share)	—	—	—	—	—	(785)	—	(785)
Compensation expense related to stock options granted	—	—	—	—	268	—	—	268
Purchase of homebuilding inventory	195,815	2	—	—	2,856	—	—	2,858
Net income	—	—	—	—	—	31,194	—	31,194
Balance, December 31, 2003	753,333	8	11,583,973	165	332,779	(202,357)	(27,267)	103,328
Repurchase of common stock	—	—	(152,094)	—	—	—	(2,093)	(2,093)
Retirement of treasury stock	—	—	—	(4)	(2,526)	—	2,530	—
Stock options exercised	—	—	996,083	10	5,870	—	—	5,880

Income tax benefits for nonqualified stock option exercises	—	—	—	—	331	—	—	331
Five-for-four common stock split	—	—	2,894,930	41	(41)	—	—	—
Dividends on cumulative preferred stock (\$1.20 per share)	—	—	—	—	—	(904)	—	(904)
Compensation expense related to stock options granted	—	—	—	—	433	—	—	433
Net income	—	—	—	—	—	44,708	—	44,708
Balance, December 31, 2004	753,333	8	15,322,892	212	336,846	(158,553)	(26,830)	151,683
Repurchase of common stock	—	—	(603,016)	—	—	—	(11,928)	(11,928)
Retirement of preferred stock	(4,500)	(1)	—	—	(56)	—	—	(57)
Stock issued in connection with conversion of convertible debt	—	—	4,595,579	46	56,204	—	—	56,250
Acquisition of interests in partnerships and joint ventures	—	—	85,402	—	1,771	—	—	1,771
Dividends on cumulative preferred stock (\$1.20 per share)	—	—	—	—	—	(899)	—	(899)
Stock options exercised	—	—	1,463,159	15	6,066	—	—	6,081
Three-for-two common stock split	—	—	7,703,348	106	(106)	—	—	—

Compensation expense related to stock options granted	—	—	—	—	1,020	—	—	1,020
Income tax benefits for non-qualified stock option exercises	—	—	—	—	786	—	—	786
Net income	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>145,791</u>	<u>—</u>	<u>145,791</u>
Balance, December 31, 2005	<u>748,833</u>	<u>\$ 7</u>	<u>28,567,364</u>	<u>\$ 379</u>	<u>\$402,531</u>	<u>\$ (13,661)</u>	<u>\$(38,758)</u>	<u>\$ 350,498</u>

The accompanying notes are an integral part of these Consolidated Financial Statements.

Table of ContentsTARRAGON CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Years Ended December 31,		
	2005	2004	2003
	(dollars in thousands)		
Cash Flows from Operating Activities			
Net income	\$ 145,791	\$ 44,708	\$ 31,194
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Deferred income taxes	59,073	14,575	—
(Gain) loss on disposition of other assets	300	(2,075)	—
Gain on sale of real estate	(71,134)	(18,366)	(24,341)
Litigation, settlements, and other claims	1,214	250	(60)
Minority interests in income of consolidated partnerships and joint ventures	2,564	3,818	2,590
Depreciation and amortization	28,499	25,915	23,678
Provision for estimated losses and impairment charges	3,066	1,133	—
Equity in income of partnerships and joint ventures	(97,295)	(21,530)	(22,476)
Noncash stock-based compensation	1,020	433	268
Deposits on purchases of homebuilding inventory	(12,002)	(5,179)	(1,918)
Changes in other operating assets and other liabilities, net of effects of non-cash investing and financing activities:			
Homebuilding inventory	(557,739)	(117,405)	(306)
Contracts receivable	49,999	43,214	—
Interest receivable	23	83	(705)
Other assets	(7,341)	(23,553)	(560)
Other liabilities	1,136	9,015	(2,568)
Interest payable	(38,349)	(20,288)	466
Net cash provided by (used in) operating activities	(491,175)	(65,252)	5,262
Cash Flows from Investing Activities			
Purchase of rental apartment communities	(39,667)	(15,526)	—
Purchase of land for development	(467)	(4,535)	(2,156)
Proceeds from the sale of real estate	86,653	14,706	24,244
Property capital improvements	(6,711)	(8,412)	(11,161)
Costs of developing rental apartment communities	(45,980)	(11,118)	(10,233)
Earnest money deposits paid	(1,186)	(1,196)	(87)
Note receivable collections	747	18	152
Net distributions from partnerships and joint ventures	88,864	16,735	12,120
Net advances to partnerships and joint ventures for development costs or for the purchase of land for development	(3,749)	(27,063)	(35,271)
Net cash acquired with consolidation of partnerships and joint ventures	50	225	—

The accompanying notes are an integral part of these Consolidated Financial Statements.

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TARRAGON CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

	For the Years Ended December 31,		
	2005	2004	2003
	(dollars in thousands)		
Cash Flows from Investing Activities (continued)			
Proceeds from disposition of other assets	\$ —	\$ 2,075	\$ —
Distributions to minority partners of consolidated partnerships and joint ventures	(3,526)	(1,010)	(1,245)
Buyout of minority partners	(21,850)	(11,081)	—
Other	310	—	—
Net cash provided by (used in) investing activities	<u>53,488</u>	<u>(46,182)</u>	<u>(23,637)</u>
Cash Flows from Financing Activities			
Proceeds from borrowings	1,051,704	429,652	230,565
Principal payments on notes payable	(585,997)	(320,746)	(204,765)
Premium paid on conversion of convertible notes	(4,340)	—	—
Stock repurchases	(11,955)	(2,093)	(4,186)
Dividends to stockholders, including amounts accrued in prior years	(929)	(904)	(791)
Proceeds from the exercise of stock options	6,081	5,880	246
Other	(316)	85	909
Net cash provided by financing activities	<u>454,248</u>	<u>111,874</u>	<u>21,978</u>
Net increase in cash and cash equivalents	16,561	440	3,603
Cash and cash equivalents, beginning of year	<u>22,066</u>	<u>21,626</u>	<u>18,023</u>
Cash and cash equivalents, end of year	<u>\$ 38,627</u>	<u>\$ 22,066</u>	<u>\$ 21,626</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Interest paid	<u>\$ 65,285</u>	<u>\$ 44,585</u>	<u>\$ 23,650</u>
Income taxes paid	<u>\$ 21,987</u>	<u>\$ 470</u>	<u>\$ —</u>

The accompanying notes are an integral part of these Consolidated Financial Statements.

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TARRAGON CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

	For the Years Ended December 31,		
	2005	2004	2003
	(dollars in thousands)		
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES:			
Changes in assets and liabilities in connection with the purchase of rental apartment communities:			
Real estate	\$ 39,342	\$ 15,409	\$ —
Restricted cash	172	114	—
Other assets	555	163	—
Other liabilities	(402)	(160)	—
Cash paid	<u>\$ 39,667</u>	<u>\$ 15,526</u>	<u>\$ —</u>
Assets written off and liabilities released in connection with the sale of real estate:			
Real estate	\$108,172	\$ 24,579	\$ 27,600
Other assets	4,149	648	523
Notes and interest payable	(94,749)	(28,519)	(27,394)
Other liabilities	(2,014)	(368)	(826)
Minority interest	(39)	—	—
Gain on sale	71,134	18,366	24,341
Cash received	<u>\$ 86,653</u>	<u>\$ 14,706</u>	<u>\$ 24,244</u>
Effect on assets and liabilities of the consolidation of four apartment communities, six homebuilding projects, and one commercial property in 2004, and one apartment community in 2005:			
Real estate	\$ —	\$ 121,418	\$ —
Homebuilding inventory	17,161	114,921	—
Contracts receivable	—	78,066	—
Investments in and advances to partnerships and joint ventures	286	(72,053)	—
Restricted cash	626	17,073	—
Other assets	115	15,203	—
Cash acquired on consolidations	50	225	—
Notes and interest payable	(17,641)	(243,809)	—
Other liabilities	(597)	(23,353)	—
Minority interest	—	(7,691)	—
	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

The accompanying notes are an integral part of these Consolidated Financial Statements.

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TARRAGON CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

	For the Years Ended December 31,		
	2005	2004	2003
	(dollars in thousands)		
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES (Continued):			
Effect on assets and liabilities of the transfer of properties to an unconsolidated joint venture of one apartment community in 2003 and eleven apartment communities in 2005:			
Real estate	\$ (175,541)	\$ —	\$ (16,377)
Investments in and advances to partnerships and joint ventures	3,871	—	2,549
Restricted cash	(2,953)	—	—
Other assets	(1,683)	—	(260)
Notes and interest payable	172,640	—	13,424
Other liabilities	3,666	—	664
	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Purchase of mortgage receivable financed with note payable	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 12,826</u>
Liabilities that financed the purchase of homebuilding inventory	<u>\$ 636,381</u>	<u>\$ 77,996</u>	<u>\$ 61,279</u>
Real estate transferred to homebuilding inventory	<u>\$ 174,311</u>	<u>\$ —</u>	<u>\$ —</u>
Conversion of convertible debt to common stock	<u>\$ 56,250</u>	<u>\$ —</u>	<u>\$ —</u>

The accompanying notes are an integral part of these Consolidated Financial Statements.



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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The accompanying Consolidated Financial Statements of Tarragon Corporation, a homebuilder and real estate developer with over 30 years of experience in the real estate industry, its subsidiaries, and consolidated partnerships and joint ventures have been prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP"), the most significant of which are described in NOTE 1. "SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES." The preparation of financial statements in accordance with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The Notes to Consolidated Financial Statements are an integral part of the Consolidated Financial Statements. The data presented in the Notes to Consolidated Financial Statements are as of December 31 of each year and for the years then ended unless otherwise indicated. Dollar amounts in tables are in thousands, except per share amounts. Certain balances for 2003 and 2004 have been reclassified to conform to the 2005 presentation.

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*Basis of consolidation.* The Consolidated Financial Statements include the accounts of Tarragon, its subsidiaries, and partnerships and joint ventures (which consist primarily of limited liability companies) it controls. Tarragon is deemed to control partnerships and joint ventures that have no unaffiliated owners and for which Tarragon is designated as the manager and the outside owners are given no participating rights, as defined in the Financial Accounting Standard Board's ("FASB") Emerging Issues Task Force 96-16 ("EITF 96-16") and EITF 04-5 Consensus. All significant intercompany transactions and balances have been eliminated.

In December 2003, the FASB issued Interpretation 46-R ("FIN 46R"), "Consolidation of Variable Interest Entities," an interpretation of Accounting Research Bulletin 51, "Consolidated Financial Statements." FIN 46R changes the criteria by which one company includes another entity in its consolidated financial statements. FIN 46R requires a variable interest entity ("VIE") to be consolidated by a company if that company is exposed to a majority of the expected losses from the VIE's activities or entitled to receive a majority of the entity's residual returns or both. Additionally, if the holders of equity at risk as a group do not have controlling financial interest, the entity may be defined as a VIE. Once an entity is determined to be a VIE, the primary beneficiary must consolidate the VIE into its financial statements. We adopted the provisions of FIN 46R on January 1, 2004.

We have identified four joint ventures, over which we exercise significant influence but do not control, that qualify as VIEs and of which we are the primary beneficiary. These four entities have been consolidated in accordance with FIN 46R. Their assets and liabilities were recorded at carrying value. The four entities consist of two limited liability companies that are developing rental apartment communities, one with 328 units and the other with 90 units, one limited liability company engaged in homebuilding with a 215-unit age-restricted traditional new development, and one limited liability partnership engaged in land development. The aggregate total assets of these VIEs were \$101 million as of December 31, 2005. Of the total assets, \$23.1 million is classified as real estate held for investment, and \$72.5 million is classified as homebuilding inventory in the accompanying December 31, 2005, Consolidated Balance Sheet. Gross revenue of these VIEs for the year ended December 31, 2005, was homebuilding sales of \$10.7 million.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

*Real estate and depreciation.* Real estate held for investment is carried at cost unless an impairment is determined to exist. We periodically evaluate whether events or changes in circumstances indicate that the carrying value of any of our properties held for investment may not be recoverable. This evaluation generally consists of a review of the property's cash flow and current and projected market conditions, as well as any changes in general and local economic conditions. If an impairment loss exists based on the results of this review, the asset's carrying value is written down to estimated fair value with a charge against current earnings.

We capitalize improvements and major rehabilitation projects that increase the value of the respective property and have useful lives greater than one year except for individual expenditures less than \$10,000 that are not part of a planned renovation project. Depreciation is provided against real estate held for investment by the straight-line method over the estimated useful lives of the assets, as summarized in the following table.

Carpet and vinyl flooring	5 years
Appliances and common area upgrades	10 years
Roof replacements	10-15 years
Boiler/HVAC replacements	10-20 years
Plumbing replacements and apartment upgrades	20 years

Properties for which we have implemented a plan of disposal are reclassified to assets held for sale. We cease depreciating the properties held for sale in the month following their reclassification to held for sale. These properties remain classified as held for sale until sold or until we decide to discontinue our plan of disposal.

We resume depreciating properties reclassified from held for sale to held for investment in the month of their reclassification, and depreciation expense is adjusted to record depreciation for the time during which the properties were classified as held for sale. Real estate held for sale is carried at the lower of cost or estimated fair value less estimated costs to sell.

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" operating results for assets sold or held for sale are presented as discontinued operations for current and all prior years presented.

*Homebuilding inventory.* Homebuilding inventory consists of land and land improvements and construction in progress. Land and land improvements include costs of land acquired and any additional improvement costs to ready land for use. Construction in progress includes development costs of new construction of condominiums, townhomes, high- and mid-rise developments and acquisition and development costs of condominium conversions in various stages of construction. Homebuilding inventory, including capitalized interest and real estate taxes, is carried at the lower of cost or fair value determined by evaluation of individual projects. Whenever events or circumstances indicate that the carrying value of homebuilding inventory may not be recoverable, the related assets are written down to their estimated fair value less selling costs.

*Warranties.* We provide warranties on workmanship and structural integrity in accordance with statutory requirements, which vary by state. Warranty reserves have been established by charging cost of sales and recording a warranty liability. The amounts charged are estimated by management to be adequate to cover expected warranty-related costs under all unexpired warranty obligation periods.



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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

*Capitalized interest.* We capitalize interest on funds used in constructing property from the date of initiation of construction activities through the time the property is ready for leasing or sale. Interest of \$42.6 million, \$14.2 million, and \$1.7 million was capitalized during 2005, 2004, and 2003, respectively. Total interest incurred for 2005, 2004, and 2003 was \$70.3 million, \$39.9 million, and \$25.6 million, respectively.

*Cash equivalents.* We consider all highly liquid debt instruments purchased with maturities of three months or less to be cash equivalents.

*Restricted cash.* Restricted cash is primarily escrow accounts, generally held by the lenders of certain of our mortgage notes payable, for taxes, insurance, and property repairs and replacements and buyer deposits on our for-sale properties held in escrow.

*Other assets.* Other assets consist primarily of notes and interest receivable, tenant accounts receivable, deferred borrowing costs, prepaid leasing commissions, and deposits on potential homebuilding projects. Deferred borrowing costs are amortized on the straight-line method (which has approximated the effective interest method) over the related loan terms, and such amortization is included in interest expense. Prepaid leasing commissions are amortized to leasing commission expense, included in property operating expenses, on the straight-line method over the related lease terms.

*Goodwill.* Goodwill was recorded in connection with the acquisitions of Tarragon Realty Advisors and Accord Properties Associates and, until December 31, 2001, was amortized on the straight-line method. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill is no longer amortized but rather carried on the balance sheet as a permanent asset and is subject to at least annual assessment for impairment by applying a fair-value-based test. The balance of goodwill was \$2.7 million as of December 31, 2005 and 2004.

*Revenue Recognition.* Homebuilding sales revenue is typically recognized at the time of closing under the completed contract method. The related profit is recognized when collectibility of the sale price is reasonably assured and the earnings process is substantially complete. When a sale does not meet the requirements for income recognition, profit is deferred until such requirements are met. For mid-rise and high-rise condominium developments, where construction typically takes eighteen months or more, the percentage-of-completion method is employed. Under this method, once construction is beyond a preliminary stage, a substantial percentage of homes are under firm contracts, buyers are committed to the extent of being unable to require refunds except for non-delivery of the home, the sale prices are deemed collectible, and remaining costs and revenues can be reasonably estimated, revenue is recorded as a portion of the value of non-cancelable sale contracts. Revenue recognized is calculated based upon the percentage of construction costs incurred in relation to total estimated construction costs. Any amounts due under sale contracts, to the extent recognized as revenue, are recorded as contracts receivable.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Rental revenue is recognized on the straight-line method. Lease terms for our apartment communities are generally for one year or less. Lease terms for our commercial properties are generally from three to five years, although they may be shorter or longer. Rental concessions are deferred and amortized on the straight-line method over the lease terms as a reduction to rental revenue. We accrue percentage rentals only after the tenants' sales have reached the threshold provided in the lease.

Interest and management fee revenue are recognized when earned. Revenue from long-term laundry and cable service contracts is deferred and amortized to income on the straight-line method over the terms of the contracts.

*Gains on Sale of Real Estate.* Gains on sales of real estate are recognized when and to the extent permitted by SFAS No. 66 – "Accounting for Sales of Real Estate." Until the requirements of SFAS No. 66 for full profit recognition have been met, transactions are accounted for using the deposit, installment, cost recovery, or financing method, whichever is appropriate.

*Investments in noncontrolled partnerships and joint ventures.* We use the equity method to account for investments in partnerships and joint ventures over which we exercise significant influence but do not control, and that are not required to be consolidated under the provisions of FIN 46R as discussed above. Under the equity method, our initial investments are increased by our proportionate share of the partnerships' and joint ventures' operating income and additional advances and decreased by our proportionate share of the partnerships' and joint ventures' operating losses and distributions received. We determine our proportionate share of the profits or losses of the partnerships and joint ventures consistent with the allocation of cash distributions in accordance with the provisions of the American Institute of Certified Public Accountants' Statement of Position ("SOP") 78-9. Our interest in intercompany transactions is eliminated.

*Stock splits.* In January 2005, the board of directors approved a three-for-two stock split effective February 10, 2005. In December 2003, the board of directors approved a five-for-four stock split effective January 15, 2004. In January 2003, the board of directors approved a three-for-two stock split effective February 14, 2003. Weighted average shares of common stock outstanding and stock options outstanding, granted, exercised, and forfeited in NOTE 8. "STOCK-BASED AWARDS" have been restated to give effect to the stock splits.

*Earnings per common share.* Earnings per share of common stock is computed based upon the weighted average number of shares outstanding during each year. All share and per share data have been restated to give effect to the three-for-two stock splits on February 14, 2003, and February 10, 2005, and the five-for-four stock split on January 15, 2004. See NOTE 7. "EARNINGS PER COMMON SHARE."

*Fair value of financial instruments.* Disclosure about fair value of financial instruments is based on pertinent information available to us as of December 31, 2005 and 2004. Considerable judgment is necessary to interpret market data and develop estimated fair values. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair values. For these reasons, the estimated fair values presented may differ significantly from the actual amounts we may pay.

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

As of December 31, 2005 and 2004, we estimated that the carrying amounts for cash and cash equivalents and restricted cash approximated fair value because of the short maturities of these instruments. In addition, we estimated that the carrying amounts of notes receivable and other liabilities approximated fair value. The fair values of notes payable are estimated by discounting future expected cash flows using current rates for loans with similar terms and maturities or, for the senior convertible notes, at the value of the common stock into which it is convertible. See NOTE 4. "NOTES AND INTEREST PAYABLE" for the disclosure of fair values of notes payable.

*Stock-based awards.* Prior to 2002 we applied Accounting Principles Board's Opinion No. 25 ("APB No. 25"), "Accounting for Stock Issued to Employees," and related Interpretations in accounting for our stock option plans. In 2002, we adopted the fair value method defined in SFAS No. 123, "Accounting for Stock-Based Compensation," which indicates that the fair value method is the preferable method of accounting and that compensation costs be recognized in financial statements rather than proforma disclosure. In December 2002, the FASB amended SFAS No. 123 by issuing SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure," which we adopted upon issuance. We elected to apply the fair value method prospectively for all options granted since the beginning of 2002.

Under APB No. 25, compensation costs related to stock options issued pursuant to compensatory plans are charged to expense over the periods during which the grantee performs the related services. Because awards under the plans vest over five years, the cost related to stock-based employee compensation included in the determination of net income for 2005, 2004, and 2003 is less than that which would have been recognized if the fair value based method had been applied to all awards. The following table illustrates the effect on net income and earnings per common share if the fair value based method had been applied to all outstanding and unvested awards in each period. For more information about our stock option plans, see NOTE 8.

"STOCK-BASED AWARDS."

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

	For the Years Ended December 31,		
	2005	2004	2003
Net income allocable to common stockholders, as reported	\$ 144,892	\$ 43,804	\$ 30,409
Add:			
Stock-based employee compensation expense included in reported net income, net of income taxes	632	259	268
Deduct:			
Total stock-based employee compensation expense determined under fair value based method for all awards, net of income taxes	(653)	(261)	(465)
Pro forma net income allocable to common stockholders	<u>\$ 144,871</u>	<u>\$ 43,802</u>	<u>\$ 30,212</u>
 Earnings per common share - basic			
Net income allocable to common stockholders, as reported	<u>\$ 5.61</u>	<u>\$ 1.94</u>	<u>\$ 1.38</u>
Net income allocable to common stockholders, pro forma	<u>\$ 5.61</u>	<u>\$ 1.94</u>	<u>\$ 1.37</u>
 Earnings per common share – assuming dilution			
Net income allocable to common stockholders, as reported	<u>\$ 4.71</u>	<u>\$ 1.65</u>	<u>\$ 1.20</u>
Net income allocable to common stockholders, pro forma	<u>\$ 4.71</u>	<u>\$ 1.65</u>	<u>\$ 1.19</u>

*Marketing costs.* Marketing costs, including advertising, incurred in connection with newly constructed rental apartment communities in lease-up are deferred and amortized to property operating expenses over the lease-up period. Marketing costs incurred in connection with for-sale communities are deferred and recorded as cost of sales when sales revenue is recognized. All other advertising costs are recorded to property operating expenses as incurred. Total advertising costs included in operating expenses were \$911,000 (net of \$297,000 included in discontinued operations) in 2005, \$950,000 (net of \$492,000 included in discontinued operations) in 2004, and \$545,000 (net of \$628,000 included in discontinued operations) in 2003.

*Concentrations of credit risks.* We maintain cash equivalents in accounts with financial institutions in excess of the amount insured by the Federal Deposit Insurance Corporation. We monitor the financial stability of the depository institutions regularly.

*Employee benefit plan.* We have a defined contribution plan covering substantially all of our employees. Our contributions are 401(k) matches determined based on 100% of the first 3% and 50% of the next 2% of the employee's salary deferrals. Total plan expense was \$505,000 in 2005, \$382,000 in 2004, and \$330,000 in 2003 and is included in corporate and property general and administrative expenses in the accompanying Consolidated Statements of Income.

*Income taxes.* We recognize deferred tax assets and liabilities based on the difference between the financial statement and income tax bases of assets and liabilities using the enacted statutory tax rate. A valuation allowance is recorded to the extent realization of deferred tax assets is uncertain.





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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 2. MINORITY INTERESTS

In February 2000, Tarragon entered into an agreement to acquire the interests of Robert C. Rohdie and certain of his affiliates in ten apartment communities. Simultaneously, he became a member of our board of directors and chief executive officer of Tarragon Development Corporation, a wholly-owned subsidiary of Tarragon. Mr. Rohdie, Tarragon's partner in the development of these projects, contributed his equity interests to Tarragon Development Company, LLC ("TDC"), a newly formed entity, in exchange for a preferred interest in the entity. For five of the ten properties that had been completed as of the date of the agreement, Mr. Rohdie received a preferred interest with a fair value of \$5 million. The initial \$5 million of purchase consideration was allocated to the five completed properties based upon their relative fair values. In accordance with the terms of the agreement, the purchase of the remaining five properties, which were in various stages of construction or development planning in February 2000, was contingent upon their completion, as defined in the agreement. During 2001, four of the five remaining apartment communities were completed, as defined in the agreement, and Mr. Rohdie received additional preferred interests in TDC with an aggregate fair value approximating \$3.8 million. Mr. Rohdie received an additional preferred interest with a fair value of approximately \$1.3 million for the final apartment community in May 2003.

Mr. Rohdie's preferred interest earns a guaranteed return. For 80% of the preferred interest, it is a guaranteed fixed return of 5% for the first two years, increasing by 1% per year until it reaches 10% in year seven. The remaining 20% of the preferred interest earns an amount equal to cash dividends payable, if any, on 668,096 shares (adjusted to give effect to the February 2005 three-for-two stock split) of Tarragon common stock. Mr. Rohdie received distributions of \$577,722 in 2003, \$421,889 in 2004, and \$623,556 in 2005 in payment of this guaranteed return.

Mr. Rohdie can convert his preferred interest in TDC into 668,096 shares of our common stock and preferred stock with a face value of up to \$8 million and a like dividend to his guaranteed fixed return. If we do not have available a class of preferred stock outstanding at the time of the conversion, or at our discretion, we may pay the cash value of Mr. Rohdie's preferred interest over three years. Beginning in February 2006, Mr. Rohdie may elect to convert his preferred interest into cash, payable over three years. The cash value that would be payable for the conversion of the preferred interest is equal to the sum of (1) the liquidation preference multiplied by the number of shares of preferred stock payable upon conversion (550,000 shares as of December 31, 2005) and (2) the market value of 668,096 shares of our common stock. As of December 31, 2005, the cash value was \$20,376,148.

Tarragon is the sole manager of TDC and makes all decisions regarding the operation, management, or control of its business and therefore consolidates this entity. Mr. Rohdie's interest in TDC is presented as a minority interest. The guaranteed fixed return payable to Mr. Rohdie is being recorded based on an annual effective yield of 8.53% and is reflected in "Minority interests in income of consolidated partnerships and joint ventures" in the accompanying Consolidated Statements of Income.

In July 2004, we purchased the \$9.5 million preferred interests of the outside partner in Antelope Pines Estates, L.P., and Woodcreek Garden Apartments, L.P. We sold Antelope Pines in December 2004 and Woodcreek Garden in January 2005. In accordance with SFAS No. 144, the operating results of these properties, along with the gains on sale, have been presented in discontinued operations for all periods presented in the accompanying Consolidated Statements of Income. See NOTE 13. "ASSETS HELD FOR SALE."

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 2. MINORITY INTERESTS (Continued)

During 2005, we purchased the interests of our outside partners in four separate entities, which were presented as minority interests. In April 2005, we purchased the 30% outside member's interest in Fenwick Tarragon Apartments, L.L.C. for \$1 million. In May 2005, we purchased the 30% outside partners' interest in Guardian-Jupiter Partners, Ltd., for \$5 million. We purchased the 30% outside member's interest in Summit/Tarragon Murfreesboro, L.L.C. for \$1.5 million in September 2005. Lastly, also in September 2005, we purchased the 30% outside member's interest in Lake Sherwood Partners, L.L.C. for \$3.4 million. The excess of the aggregate \$11.9 million purchase prices over the carrying amounts of the minority interests was capitalized to the basis of the properties.

NOTE 3. INVESTMENTS IN AND ADVANCES TO PARTNERSHIPS AND JOINT VENTURES

Investments in and advances to partnerships and joint ventures consisted of the following at December 31:

	Profits Interest	Carrying Amount	
		2005	2004
801 Pennsylvania Avenue	50%	\$ —	\$ 30
Ansonia Apartments, L.P. (1)	89%	—	367
Ansonia Liberty, L.L.C. (1)	90%	—	10
Choice Home Financing, L.L.C	50%	425	—
Danforth Apartment Owners, L.L.C. (1), (2)	99%	—	—
Delaney Square, L.L.C	50%	—	5,778
Hoboken joint ventures:			
900 Monroe Street Development, L.L.C	63%	4,134	1,792
Block 106 Development, L.L.C	63%	11,228	—
Block 99/102 Development, L.L.C	55%	15,956	5,622
Block 144 Development, L.L.C	63%	4,026	282
Madison Warehouse Development, L.L.C	63%	10,918	1,975
TDC/Ursa Hoboken Sales Center, L.L.C	48%	1,455	1,140
Thirteenth Street Development, L.L.C	50%	—	12,749
Upper Grand Realty, L.L.C	50%	—	345
Larchmont Associates, L.P. (3)	57%	—	2,026
LOPO, L.P.	50%	6,251	—
Merritt Stratford, L.L.C	50%	256	229
Orchid Grove, L.L.C	50%	2,774	4,646
Orion Towers Tarragon L.L.P.	70%	15,662	2,100
Park Avenue Tarragon, L.L.C	50%	5,456	6,119
Tarragon Calistoga, L.L.C	80%	632	632
Tarragon Savannah I & II, L.L.C. (1), (2)	99%	—	2,232
Vineyard at Eagle Harbor, L.L.C. (2)	99%	—	—
		<u>\$ 79,173</u>	<u>\$ 48,074</u>

- (1) In November 2005, Tarragon contributed its interests in eleven wholly owned properties, (Ansonia Liberty, Danforth Apartments Owners, and Tarragon Savannah I & II) to Ansonia in exchange for an increased interest in Ansonia from 70% to 89.44%.

- (2) In November 2005, we acquired the interest of Aetna in these joint ventures. Our interests in Danforth Apartment Owners, L.L.C. and Tarragon Savannah I & II, L.L.C. were contributed to Ansonia Apartments, L.P. Vineyard at Eagle Harbor, L.L.C. is now a consolidated entity.
- (3) This partnership's sole asset, Arbor Glen Apartments, was sold in January 2005.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)NOTE 3. INVESTMENTS IN AND ADVANCES TO PARTNERSHIPS AND JOINT VENTURES  
(Continued)

We exercise significant influence over but hold noncontrolling interests in each of the above partnerships or joint ventures or our outside partners have significant participating rights, as defined in the Financial Accounting Standard Board's Emerging Issues Task Force 96-16 and 04-5 Consensus. Therefore, we account for our investments in these partnerships and joint ventures using the equity method.

*Ansonia Apartments, L.P.* Our partner in Ansonia Apartments, L.P. ("Ansonia") is Ansonia LLC, the members of which are Robert Rothenberg, Saul Spitz, Eileen Swenson, Richard and Rebecca Frary, and Joel Mael. Messrs. Rothenberg and Spitz and Ms. Swenson became executive officers of Tarragon, and Mr. Rothenberg was appointed to our board of directors, in September 2000. Mr. Frary was appointed as a member of our board of directors in April 2004. Mr. Frary is also a partner in Tarragon Calistoga, L.L.C.

Tarragon's investment in Ansonia was fully recovered in 2002 from distributions to the partners of cash proceeds from property sales, mortgage refinancings, supplemental mortgages, and operations.

Equity in income of partnerships and joint ventures in the accompanying Consolidated Statements of Income includes \$64.4 million (including the amount resulting from the financing transaction discussed below) \$6.3 million, and \$8.2 million, respectively, for the years ended December 31, 2005, 2004, and 2003 of distributions in excess of our share of Ansonia's earnings.

In November 2005, we contributed our interests in eleven consolidated properties and three unconsolidated properties to Ansonia in exchange for an increased ownership interest in Ansonia. The assets and liabilities were recorded on the books of Ansonia at Tarragon's or the previous joint ventures' historical cost basis, and Tarragon recognized no gain or loss on this transaction. Simultaneously, Ansonia closed a \$391 million non-recourse structured financing secured by first and second lien mortgages on 23 of its properties and pledges of equity interests in the property-owning entities. After transaction costs and repayment of existing debt, this financing generated \$70 million of net cash proceeds. We received a distribution of \$64 million from Ansonia, representing our share of the net proceeds, and the balance of the net financing proceeds was distributed to our partners. This transaction reduced consolidated debt by \$148 million and generated \$60 million in income from distributions in excess of our investment in Ansonia .

*Hoboken joint ventures.* In November 2004, we entered into an agreement to purchase a portion of one of our partners' interests in various joint venture projects in The Upper Grand neighborhood of Hoboken, New Jersey, for an aggregate purchase price of \$15 million. Pursuant to this agreement, we paid \$10 million in November 2004 and the balance in February 2005 in exchange for assignments of all of Ursa Development Group, Inc.'s interests in the Block 88 and Adams Street developments, 50% of its interests in the Block 99 development, and 25% of its interests in all other Hoboken joint ventures except Thirteenth Street Development. In connection with this transaction, we acquired control of Adams Street Development and Block 88 Development and began consolidating these entities in November 2004. The purchase price was allocated among the interests acquired based on the relative fair values of their projects.

*Loan Guarantees for Unconsolidated Partnerships and Joint Ventures.* We have guaranteed two construction loans and three land loans of five unconsolidated joint ventures as of December 31, 2005. Our guarantee on these five loans is limited to \$127.3 million on fully funded debt of \$130.9 million. At December 31, 2005, we guaranteed \$89.9 million of the \$93.4 million outstanding on that date. At December 31, 2005, in connection with these guarantees, we have recorded liabilities totaling \$2.1 million, which are presented in other liabilities in the accompanying Consolidated Balance Sheet.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)NOTE 3. INVESTMENTS IN AND ADVANCES TO PARTNERSHIPS AND JOINT VENTURES  
(Continued)

As of December 31, 2004, we had guaranteed two mortgages and two construction loans of four unconsolidated joint ventures. Our guarantee on these four loans was limited to \$92.5 million on fully funded debt of \$194.5 million. At December 31, 2004, we guaranteed \$63.3 million of the \$152.5 million outstanding on that date. At December 31, 2004, in connection with these guarantees, we had recorded liabilities totaling \$392,000, which are presented in other liabilities in the accompanying Consolidated Balance Sheet. All four of these loans were repaid during 2005.

Below are unaudited summarized financial data for Ansonia Apartments and Park Avenue Tarragon individually and combined for our other unconsolidated partnerships and joint ventures that are not individually significant as of and for the periods indicated.

*December 31, 2005*

	Ansonia Apartments	Park Avenue Tarragon	Other	All Partnerships
Homebuilding inventory	\$ —	\$ 17,317	\$ 182,307	\$ 199,624
Real estate	358,895	—	14,097	372,992
Accumulated depreciation	(65,613)	—	(7,573)	(73,186)
Other assets, net	15,687	3,831	16,583	36,101
Notes and interest payable	(420,152)	—	(114,602)	(534,754)
Other liabilities	(5,360)	(5,234)	(16,130)	(26,724)
Partners' capital (deficit)	<u>\$ (116,543)</u>	<u>\$ 15,914</u>	<u>\$ 74,682</u>	<u>\$ (25,947)</u>
Our proportionate share of partners' capital (deficit)	\$ (100,154)	\$ 4,287	\$ 52,616	\$ (43,251)
Cash distributions in excess of investment	83,416	—	—	83,416
Outside partner's share of undistributed cash	676	—	13,274	13,950
Loss in excess of investment unrecognized	15,452	—	—	15,452
Liability established (reversed) for debt guarantees	—	—	2,070	2,070
Costs associated with investment in joint ventures	<u>610</u>	<u>1,169</u>	<u>5,757</u>	<u>7,536</u>
Investments in and advances to partnerships and joint ventures	<u>\$ —</u>	<u>\$ 5,456</u>	<u>\$ 73,717</u>	<u>\$ 79,173</u>
<i>Year Ended December 31, 2005</i>				
Homebuilding sales	\$ —	\$ 130,440	\$ 100,366	\$ 230,806
Cost of homebuilding sales	—	(89,873)	(70,986)	(160,859)

Rental revenue	24,583	—	11,571	36,154
Mortgage banking income	—	—	916	916
Property and other operating expenses	(12,655)	—	(5,097)	(17,752)
Interest expense	(25,951)	—	(4,553)	(30,504)
Depreciation expense	(4,112)	—	(1,906)	(6,018)
Income from continuing operations	(18,135)	40,567	30,311	52,743
Discontinued operations				
Loss from operations (1)	—	—	(263)	(263)
Loss on sale of real estate	—	—	(350)	(350)
Net income	(18,135)	40,567	29,698	52,130
Elimination of interest and management fees paid to Tarragon	1,163	132	377	1,672
Net income before interest and management fees paid to Tarragon	<u>\$ (16,972)</u>	<u>\$ 40,699</u>	<u>\$ 30,075</u>	<u>\$ 53,802</u>
Equity in income of partnerships and joint ventures:				
Tarragon's share of net income before interest and management fees paid to Tarragon	\$ (15,452)	\$ 19,600	\$ 12,829	\$ 16,977
Cash distributions in excess of investment	64,778	—	88	64,866
Loss in excess of investment unrecognized	15,452	—	—	15,452
Equity in income of partnerships and joint ventures	<u>\$ 64,778</u>	<u>\$ 19,600</u>	<u>\$ 12,917</u>	<u>\$ 97,295</u>

(1) Revenue presented in discontinued operations was \$172,000.

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 3. INVESTMENTS IN AND ADVANCES TO PARTNERSHIPS AND JOINT VENTURES  
(Continued)

*December 31, 2004*

	<u>Ansonia Apartments</u>	<u>Park Avenue Tarragon</u>	<u>Other</u>	<u>All Partnerships</u>
Homebuilding inventory	\$ —	\$ 89,164	\$ 55,624	\$ 144,788
Real estate	96,430	—	90,009	186,439
Accumulated depreciation	(18,152)	—	(19,213)	(37,365)
Other assets, net	3,947	2,223	90,389	96,559
Notes and interest payable	(105,107)	(79,334)	(145,843)	(330,284)
Other liabilities	(1,778)	(584)	(16,980)	(19,342)
Partners' capital	<u>\$ (24,660)</u>	<u>\$ 11,469</u>	<u>\$ 53,986</u>	<u>\$ 40,795</u>
Our proportionate share of partners' capital	\$ (17,648)	\$ 6,009	\$ 29,566	\$ 17,927
Cash distributions in excess of investment	19,793	—	2,206	21,999
Liability established for debt guarantees	—	114	276	390
Advances	<u>(1,778)</u>	<u>(4)</u>	<u>9,540</u>	<u>7,758</u>
Investments in and advances to partnerships and joint ventures	<u>\$ 367</u>	<u>\$ 6,119</u>	<u>\$ 41,588</u>	<u>\$ 48,074</u>

*Year Ended December 31, 2004*

Homebuilding sales	\$ —	\$ —	\$ 95,031	\$ 95,031
Cost of homebuilding sales	—	—	(65,681)	(65,681)
Rental revenue	20,791	—	15,073	35,864
Property and other operating expenses	(10,463)	—	(6,749)	(17,212)
Interest expense	(7,289)	—	(5,341)	(12,630)
Depreciation expense	<u>(3,420)</u>	<u>—</u>	<u>(2,676)</u>	<u>(6,096)</u>
Income from continuing operations	(381)	—	29,657	29,276
Discontinued operations	—	—	—	—
Loss from operations (1)	—	—	(873)	(873)
Gain on sale of real estate	—	—	2,604	2,604
Net income	<u>(381)</u>	<u>—</u>	<u>31,388</u>	<u>31,007</u>
Elimination of interest and management fees paid to Tarragon	<u>1,046</u>	<u>—</u>	<u>410</u>	<u>1,456</u>



Net income before interest and management fees paid to Tarragon	\$ <u>665</u>	\$ <u>—</u>	\$ <u>31,798</u>	\$ <u>32,463</u>
Equity in income of partnerships and joint ventures:				
Tarragon's share of net income before interest and management fees paid to Tarragon	\$ 466	\$ —	\$ 16,410	\$ 16,876
Cash distributions in excess of investment	5,871	—	(55)	5,816
Impairment loss	<u>—</u>	<u>—</u>	<u>(1,162)</u>	<u>(1,162)</u>
Equity in income of partnerships and joint ventures	\$ <u>6,337</u>	\$ <u>—</u>	\$ <u>15,193</u>	\$ <u>21,530</u>

(1) Revenue presented in discontinued operations was \$1.7 million.

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 3. INVESTMENTS IN AND ADVANCES TO PARTNERSHIPS AND JOINT VENTURES  
(Continued)

<i>Year Ended December 31, 2003</i>	Ansonia Apartments	Other	All Partnerships
Homebuilding sales	\$ —	\$ 97,583	\$ 97,583
Cost of homebuilding sales	—	(77,381)	(77,381)
Rental revenue	20,376	25,510	45,886
Property and other operating expenses	(10,410)	(13,327)	(23,737)
Interest expense	(7,053)	(10,117)	(17,170)
Depreciation expense	(3,355)	(5,480)	(8,835)
Income from continuing operations	(442)	16,788	16,346
Discontinued operations			
Loss from operations (1)	—	(1,477)	(1,477)
Net income	(442)	15,311	14,869
Elimination of interest and management fees paid to Tarragon	1,010	3,315	4,325
Net income before interest and management fees paid to Tarragon	<u>\$ 568</u>	<u>\$ 18,626</u>	<u>\$ 19,194</u>
Equity in income of partnerships and joint ventures:			
Tarragon's share of net income before interest and management fees paid to Tarragon	\$ 398	\$ 13,271	\$ 13,669
Cash distributions in excess of investment	7,675	1,445	9,120
Impairment loss	—	(313)	(313)
Equity in income of partnerships and joint ventures	<u>\$ 8,073</u>	<u>\$ 14,403</u>	<u>\$ 22,476</u>

(1) Revenue presented in discontinued operations was \$1.6 million.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)NOTE 4. NOTES AND INTEREST PAYABLE

Notes and interest payable consisted of the following at December 31:

	2005		2004	
	Estimated Fair Value	Book Value	Estimated Fair Value	Book Value
Loans on homebuilding developments	\$ 762,174	\$ 760,152	\$ 217,674	\$ 217,674
Mortgages on real estate	60,832	58,969	488,300	478,135
Subordinated unsecured notes	65,000	65,000	—	—
Senior convertible notes	9,687	5,750	62,000	62,000
Other notes payable	11,530	11,144	8,400	8,400
Accrued interest	5,312	5,312	4,038	4,038
	<u>\$ 914,535</u>	<u>\$ 906,327</u>	<u>\$ 780,412</u>	<u>\$ 770,247</u>

Notes payable at December 31, 2005, bear interest at fixed rates from 1% to 8.79% per annum and variable rates currently ranging from 6.06% to 9.89% and mature from 2006 through 2051. The loans are generally nonrecourse, with the exception of construction loans, and are collateralized by deeds of trust on real estate with an aggregate net carrying value of \$1.1 billion. Some of our construction loans contain certain financial covenants. We are in compliance with all of the financial covenants as of December 31, 2005.

On June 15, 2005, we issued \$40 million of subordinated unsecured notes due June 30, 2035. The notes bear interest, payable quarterly, at a rate of 8.71% through June 30, 2010, and thereafter at a variable rate equal to LIBOR plus 4.4% per annum. The notes are prepayable after June 30, 2010 at financial. On September 12, 2005, we issued an additional \$25 million of subordinated unsecured notes due October 30, 2035. The notes bear interest, payable quarterly, at a rate of 8.79% through October 30, 2010, and thereafter at a variable rate equal to LIBOR plus 4.4% per annum. The notes are prepayable after October 30, 2010 at par. These notes contain a debt service coverage ratio requirement and a minimum net worth requirement. We are in compliance with both of these financial covenants as of December 31, 2005.

On September 16, 2004, we completed the sale of \$50 million principal amount of 8% Senior Convertible Notes Due 2009 (the "Notes"). The Notes are general, senior, unsecured obligations of Tarragon, bear interest at the rate of 8% per annum and are convertible into our common stock at a conversion rate of 81.6993 shares per \$1,000 in principal amount of Notes (equal to a conversion price of \$12.24 per share of our common stock), subject to adjustment in certain instances. On November 19, 2004, we sold an additional \$12 million principal amount of the Notes.

Interest on the Notes is payable semi-annually in March and September, and the principal balance of the Notes is payable at maturity in September 2009. Prior to September 16, 2007, the Notes are not redeemable. After that date, we have the right, but not the obligation, to redeem the Notes (in whole or in part) for cash at a redemption price of \$1,000 original amount of Note, plus accrued and unpaid interest if the closing price of our common stock equals or exceeds 150% of the then applicable conversion price for 20 of 30 consecutive trading days. The Notes may also be subject to a "put option" by the Holders if a fundamental change occurs, as that term is defined in the Note Indenture. The Notes and the common stock issuable upon conversion of the Notes are now covered by Registration Statement No. 333-1211258 declared effective by the Commission on January 24, 2005. We will not receive any proceeds from the sale by the named selling security holders of the Notes or the shares of common stock issuable upon conversion of the Notes pursuant to such Registration.

On July 1, 2005, we converted \$2 million of the Notes into 163,399 shares of common stock after presentment for conversion by a noteholder. On August 23, 2005, an additional \$54.25 million of the Notes were converted into shares of our common stock pursuant to an offer to holders of the Notes. Each holder who converted their convertible notes prior to the expiration of the offer received 81.6993 shares of our common stock and \$80 in cash for each \$1,000 principal amount of convertible notes delivered for conversion plus accrued and unpaid interest. In connection with the offer, we issued 4,432,181 shares of common stock. We paid approximately \$1.9 million in accrued interest for the period from March 16, 2005 through August 23, 2005 and

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 4. NOTES AND INTEREST PAYABLE (Continued)

a premium of \$4.3 million and wrote off \$2.9 million of deferred financing expenses. The outstanding balance of remaining senior convertible notes was \$5.75 million at December 31, 2005.

Other notes payable as of December 31, 2005 consist of \$4.3 million of unsecured loans and \$7 million outstanding under a bank line of credit. We have \$3.6 million outstanding under a bank line of credit secured by mortgages on four properties and Tarragon common stock pledged by affiliates of William S. Friedman, our chief executive officer and chairman of our board of directors. See NOTE 9. "RELATED PARTY TRANSACTIONS." At December 31, 2005, \$12.4 million was available to us, and the outstanding balance is included in Mortgages on Real Estate in the table above. We also have an unused \$20 million unsecured line of credit with affiliates of Mr. Friedman and a \$10 million unsecured line of credit under which \$3 million was available at December 31, 2005. For the terms of the line of credit with affiliates of Mr. Friedman, see NOTE 9. "RELATED PARTY TRANSACTIONS."

At December 31, 2005, scheduled principal payments on notes payable are due as follows:

2006	\$ 303,644
2007	329,992
2008	119,033
2009	25,488
2010	26,860
Thereafter	95,998
	<u>\$ 901,015</u>

NOTE 5. COMMON STOCK REPURCHASE PROGRAM

The board of directors has authorized a common stock repurchase program. In 2005, 2004, and 2003, Tarragon repurchased an aggregate of 1,030,553 shares of its common stock in open market and negotiated transactions at a cost of \$18.2 million. Our cumulative cost of common stock repurchases is \$54.8 million. As of December 31, 2005, Tarragon had authorization to repurchase an additional 106,975 common shares.

NOTE 6. 10% CUMULATIVE PREFERRED STOCK

Our outstanding 10% cumulative preferred stock pays a fixed dividend of \$1.20 per year, payable quarterly, and has a liquidation value of \$12 per share. We may redeem our preferred stock at any time after June 30, 2003 at the liquidation value plus a premium of \$0.50 per share, which declines by \$0.10 per share each year thereafter. No mandatory redemption or "sinking fund" is required.

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 7. EARNINGS PER COMMON SHARE

Earnings per common share have been computed based on the weighted average number of shares of common stock outstanding. Following is a reconciliation of earnings per common share and earnings per common share – assuming dilution. The information has been restated to give effect to the three-for-two stock splits in February 2003 and February 2005 and the five-for-four stock split in January 2004.

	For the Years Ended December 31,		
	2005	2004	2003
Net income allocable to common stockholders, as reported	\$ 144,892	\$ 43,804	\$ 30,409
Add:			
Interest expense on convertible notes, net of income taxes	6,757	918	—
Net income allocable to common stockholders - assuming dilution	<u>\$ 151,649</u>	<u>\$ 44,722</u>	<u>\$ 30,409</u>
Weighted average shares of common stock used in computing earnings per share	25,823,431	22,528,561	21,975,137
Convertible preferred interest of minority partner in consolidated joint venture	668,096	668,096	668,096
Convertible notes	3,404,846	1,313,008	—
Effect of stock appreciation rights	97,152	7,529	—
Effect of stock options	<u>2,202,790</u>	<u>2,530,179</u>	<u>2,743,569</u>
Weighted average shares of common stock used in computing earnings per share – assuming dilution	<u>32,196,315</u>	<u>27,047,373</u>	<u>25,386,802</u>
Earnings per common share			
Net income allocable to common stockholders - basic	<u>\$ 5.61</u>	<u>\$ 1.94</u>	<u>\$ 1.38</u>
Net income allocable to common stockholders - assuming dilution	<u>\$ 4.71</u>	<u>\$ 1.65</u>	<u>\$ 1.20</u>

The convertible preferred interest of minority partner in consolidated joint venture represents the preferred interest of Mr. Rohdie in a joint venture we consolidate (see NOTE 2. "MINORITY INTERESTS.") On a weighted average basis, options to purchase 2,760,180 shares of common stock at a price of \$4.25 in 2005, 4,435,494 shares of common stock at a price of \$4.07 in 2004, and 5,446,865 shares of common stock at a price of \$3.83 in 2003, were outstanding. During 2005, the effect of 16,146 stock options with exercise prices above the market price of our common stock is not reflected because their effect is anti-dilutive. During 2004 and 2003, the exercise prices of all options were less than the average market price of our common stock.

NOTE 8. STOCK-BASED AWARDS

Tarragon has an Independent Director Stock Option Plan (the "Director Plan"), a Share Option and Incentive Plan (the "Incentive Plan"), and an Omnibus Plan (collectively, the "Option Plans"). The Director Plan and the Incentive Plan terminated in November 2005, and there will be no future grants under these plans.

Through November 2005, under Tarragon's Director Plan, independent directors received annual awards of options to purchase 2,000 shares of Tarragon common stock on January 1 of each year. The options were immediately exercisable and expire on the earlier of the first anniversary of the date on which the director ceases to serve as a director or ten years from the date of grant. The compensation committee of our board of directors adopted a standing resolution to grant non-employee directors options to purchase 2,000 shares of Tarragon common stock on the first business day of each year under the Omnibus Plan consistent with the annual grants under the Director Plan.

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 8. STOCK-BASED AWARDS (Continued)

Through November 2005, under the Incentive Plan, incentive stock options were awarded to officers and employees of Tarragon and its subsidiaries. These stock options vest between one and five years from the date of grant and expire ten years thereafter, unless the optionees' relationship with Tarragon terminates earlier.

On June 14, 2004, our stockholders approved the adoption of an Omnibus Plan for employee and director options and stock-based awards. Under this Plan, we have a maximum of two million shares of common stock available for issuance, including an aggregate of one million shares of common stock that are available for issuance of awards other than stock options. The Plan authorizes the award of incentive stock options and non-qualified stock options to our employees and directors, as well as restricted or unrestricted stock awards or stock units; dividend equivalent rights; other stock based awards, including stock appreciation rights payable in stock or cash; and performance based and annual incentive awards. As of December 31, 2005, there were 1,722,250 shares of common stock available for grant under the Omnibus Plan.

The following table summarizes stock option activity:

	For the Years Ended December 31,					
	2005		2004		2003	
	Number of Options	Weighted Average Exercise Prices	Number of Options	Weighted Average Exercise Prices	Number of Options	Weighted A Exercise P
Outstanding at January 1	4,150,959	\$ 4.06	5,533,843	\$ 3.93	5,140,880	\$
Granted	70,125	22.96	128,619	8.46	508,127	
Exercised	(1,457,349)	3.81	(1,494,121)	3.93	(70,827)	
Forfeited	(41,968)	7.27	(17,382)	7.58	(44,337)	
Outstanding at December 31	<u>2,721,767</u>	<u>\$ 4.48</u>	<u>4,150,959</u>	<u>\$ 4.06</u>	<u>5,533,843</u>	<u>\$</u>
Exercisable at December 31	<u>2,307,752</u>	<u>\$ 3.68</u>	<u>3,489,946</u>	<u>\$ 3.73</u>	<u>4,791,070</u>	<u>\$</u>
Weighted average grant-date fair value of options granted: To employees and directors		<u>\$ 6.30</u>		<u>\$ 2.96</u>		<u>\$</u>



In  
connection  
with  
acquisitions

\$ \_\_\_\_\_

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)NOTE 8. STOCK-BASED AWARDS (Continued)

The following table summarizes stock appreciation rights ("SARs") activity:

	For the Years Ended December 31,			
	2005		2004	
	Number of SARs	Weighted Average Exercise Prices	Number of SARs	Weighted Average Exercise Prices
Outstanding at January 1	105,300	\$ 8.75	—	\$ —
Granted	311,000	10.96	105,300	8.75
Exercised	(88,150)	15.37	—	—
Forfeited	(4,354)	23.07	—	—
Outstanding at December 31	<u>323,796</u>	<u>\$ 13.74</u>	<u>105,300</u>	<u>\$ 8.75</u>
Exercisable at December 31	<u>35,650</u>	<u>\$ 10.28</u>	<u>7,800</u>	<u>\$ 8.65</u>
Weighted average grant-date fair value of SARs granted:				
To employees and directors		<u>\$ 3.49</u>		<u>\$ 2.52</u>

These stock appreciation rights have ten-year terms, are limited in appreciation to \$15 per share, and may be settled only in shares of our common stock.

The fair value of each option and stock appreciation right is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	For the Years Ended December 31,			
	2005	2004	2003	
	Granted to Employees and Directors	Granted to Employees and Directors	Granted in Connection with Acquisition of Homebuilding Inventory	Granted to Employees and Directors
Dividend yield	—	—	—	—
Expected volatility	21%	22%	22%	22%
Risk-free interest rate	3.64%	4.21%	3.78%	3.90%
Expected lives (in years)	4.62	6.58	8	8
Forfeitures	1.8%	1.8%	—	1.4%

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 8. STOCK-BASED AWARDS (Continued)

The following table summarizes information about the options outstanding at December 31, 2005:

Range of Exercise Prices	Options	Outstanding		Exercisable	
		Weighted Average Contractual Life	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
\$ 1.63-3.53	1,691,839	4.60	\$ 3.14	1,691,467	\$ 3.14
4.24-5.42	773,803	5.64	4.69	548,747	4.71
7.47-8.89	126,375	7.92	8.41	46,500	8.35
9.13-12.07	68,250	8.27	9.85	21,038	10.60
20.93-25.32	61,500	9.53	24.56	—	—
<u>\$ 1.63-25.32</u>	<u>2,721,767</u>	<u>5.26</u>	<u>\$ 4.48</u>	<u>2,307,752</u>	<u>\$ 3.68</u>

In January 2006, we granted options to purchase 165,500 shares, of which 14,000 were immediately exercisable, and 81,086 shares of restricted stock under the Omnibus Plan.

The following table summarizes information about the SARs outstanding at December 31, 2005:

Range of Exercise Prices	SARs	Outstanding		Exercisable	
		Weighted Average Contractual Life	Weighted Average Exercise Price	SARs	Weighted Average Exercise Price
\$ 8.47-12.11	155,199	8.94	\$ 10.61	33,550	\$ 9.57
16.33-19.97	167,197	9.07	16.58	700	19.10
21.20-23.63	1,400	9.38	22.88	1,400	22.88
<u>\$ 8.47-23.63</u>	<u>323,796</u>	<u>9.01</u>	<u>\$ 13.74</u>	<u>35,650</u>	<u>\$ 10.28</u>

NOTE 9. RELATED PARTY TRANSACTIONS

With the approval of our board of directors, affiliates of William S. Friedman and his wife, Lucy N. Friedman made a \$20 million unsecured line of credit available to us. Interest is accrued on advances under the line of credit at LIBOR plus 1% per annum (or the lowest rate at which credit is offered to us by any third party). We incurred interest on this line of credit of \$49,000 in 2005, \$12,000 in 2004, and \$2,000 in 2003. At December 31, 2005, there was no outstanding balance under the line of credit. Effective in January 2006, this line of credit was increased to \$30 million and its term renewed and extended until January 2008.

As an accommodation to us, Mr. and Mrs. Friedman and their affiliates have pledged 975,000 shares of Tarragon common stock to secure an \$18.3 million line of credit with a bank. We have agreed to indemnify Mr. and Mrs. Friedman and their affiliates from any loss, cost, or liability associated with these accommodation pledges or the lines of credit. As collateral for our indemnification obligations, we have agreed to pledge shares of our treasury stock to Mr. and Mrs. Friedman and their affiliates.

Prior to 2004, Tarragon provided property management services for rental properties owned by affiliates of Mr. Friedman and received property management fees of \$15,000 in 2003 from these properties.

Tarragon provides asset and property management services for certain properties owned by partnerships and joint ventures accounted for by the equity method. Tarragon received management fees of \$1.7 million in

2005, \$1.5 million in 2004, and \$1.7 million in 2003 from these properties and recognized as income \$442,000,

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9. RELATED PARTY TRANSACTIONS (Continued)

\$374,000, and \$414,000 for the portion of the fee allocable to our joint venture partners. The remaining portion of the fees was treated as a return of our investment.

Tarragon's partners in Ansonia Apartments, L.P. and Tarragon Calistoga, L.L.C. include certain directors and officers of Tarragon.

In 2003, Tarragon recognized as interest income \$678,000 on advances to One Las Olas, Ltd., a partnership that we accounted for on the equity method until January 1, 2004. The income recognized was the portion of the interest allocable to our partners. The remainder of the interest was treated as a reduction of project costs of Las Olas River House.

Tarragon recognized income of \$61,000 in 2004 and \$291,000 in 2003 in connection with development and construction of one of our homebuilding projects in which outside partners hold an interest. The income represents the portion of a manager's fee allocable to the outside partners' interest.

NOTE 10. INCOME TAXES

The provision for income taxes consists of the following:

	For the Years Ended December 31,		
	2005	2004	2003 (1)
Current:			
Federal	\$32,678	\$ 925	\$ —
State	(2,208)	600	—
	<u>30,470</u>	<u>1,525</u>	<u>—</u>
Deferred:			
Federal	49,689	13,510	—
State	9,385	—	—
	<u>59,074</u>	<u>13,510</u>	<u>—</u>
Income tax expense	<u>\$89,544</u>	<u>\$15,035</u>	<u>\$ —</u>

(1) No current or deferred income tax expense was recognized in 2003 due to the application of net operating loss carryforwards.

Income taxes payable consists of the following:

	December 31,	
	2005	2004
Current	\$ 9,223	\$ 1,524
Deferred	71,793	12,720
Income taxes payable	<u>\$81,016</u>	<u>\$14,244</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)NOTE 10. INCOME TAXES (Continued)

A reconciliation of computed income taxes to actual income taxes follows:

	For the Years Ended December 31,		
	2005	2004	2003
Income from continuing operations before taxes	\$165,148	\$40,748	\$ 8,487
Statutory Federal income tax rate	35%	35%	34%
Income taxes at statutory rate	57,802	14,262	2,886
State income taxes, net of Federal benefit	5,080	1,429	293
Adjustment to correct deferred tax liabilities	—	2,112	—
Other	(43)	(581)	23
Change in valuation allowance	—	(9,822)	(3,202)
Income tax provision	<u>\$ 62,839</u>	<u>\$ 7,400</u>	<u>\$ —</u>

The following table discloses the components of the deferred tax amounts at December 31, 2005 and 2004:

	December 31,	
	2005	2004
Deferred tax assets — temporary differences:		
Equity in income of partnerships and joint ventures	\$ 6,298	\$ 2,309
Allowance for losses	623	7
Prepaid rent	101	29
Deferred revenue	2,040	237
Accrued benefits	1,899	420
Accrued settlements and other	560	—
Stock-based awards	461	117
Other	5	97
Total deferred tax assets — temporary differences	11,987	3,216
Alternative minimum tax credit carryforward	—	1,594
Net operating loss carryforward	—	2,437
Total deferred tax assets	<u>11,987</u>	<u>7,247</u>
Deferred tax liabilities — temporary differences:		
Distributions from partnerships and joint ventures in excess of basis	39,318	10,179
Investments in partnerships and joint ventures	37,308	6,973
Real estate	6,153	2,815
Prepaid insurance	720	—
Straight-line rent	281	—
Total deferred tax liabilities	<u>83,780</u>	<u>19,967</u>
Net deferred tax liabilities	<u>\$ (71,793)</u>	<u>\$ (12,720)</u>

In 2004, our provision for income taxes is net of the reversal of a valuation allowance against net deferred tax assets of \$9.8 million. The valuation allowance from December 31, 2003, was reversed during the second quarter of 2004 as it was determined that realization of our deferred tax asset was more likely than not.

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 11. RENTALS UNDER OPERATING LEASES

Tarragon's rental operations include the leasing of office buildings and shopping centers subject to leases with terms greater than one year. The leases thereon expire at various dates through 2020. The following is a schedule of future minimum rentals to be received on non-cancelable operating leases as of December 31, 2005:

2006	\$ 7,307
2007	6,496
2008	5,214
2009	4,519
2010	3,459
Thereafter	2,496
	<u>\$29,491</u>

NOTE 12. COMMITMENTS AND CONTINGENCIES

In April 2003, in connection with the renovations at Pine Crest Village at Victoria Park, our contractor inadvertently disturbed asbestos-containing materials. These actions have been under investigation by the Environmental Protection Agency, the United States Attorney for the Southern District of Florida and a federal grand jury for possible violations of federal criminal laws. We are currently engaged in discussions with the United States Attorney concerning a possible resolution of this matter that would involve the imposition of fines and a felony criminal plea. At December 31, 2005, we have accrued a \$1 million loss contingency for the estimated fines. This accrual is included in other liabilities in the accompanying Consolidated Balance Sheets. In addition, one current and one former employee of Tarragon with oversight responsibility for the Pine Crest condominium conversion have received written notices from the United States Attorney advising them that they are a target of the grand jury's criminal investigation. We have incurred legal and other professional fees and costs of relocation of residents in connection with this matter of \$468,000 to date. Remediation has been completed at a cost of approximately \$795,000.

In December 2004, we were notified by our general liability insurer that it was withdrawing coverage for Orlando Central Park Tarragon, LLC, one of our subsidiaries, in connection with a negligence action pending in state court in Florida for personal injuries and damages allegedly suffered by the plaintiff as a result of the use by the outside property management company of an insecticide at the property. The extent of the property owner's liability for the plaintiff's claims is unknown at this time.

We are also party to various other claims and routine litigation arising in the ordinary course of business. We do not believe that the results of such claims and litigation, individually or in the aggregate, will have a material adverse effect on our business, financial position, or results of operations.

The following is a schedule of future minimum lease payments due on leases for equipment and office space occupied by us that expire at various dates through 2016.

	Office Space and Equipment
2006	\$ 1,143
2007	1,100
2008	1,089
2009	604

2010	337
Thereafter	<u>1,555</u>
	<u>\$ 5,828</u>



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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 13. ASSETS HELD FOR SALE

In March 2005, our board of directors approved a plan to divest substantially all of our Investment Division properties. Pursuant to this plan, we sold 15 properties and contributed our interests in 11 properties to an unconsolidated partnership during 2005. The remaining Investment Division properties we intend to sell are classified as assets held for sale as of December 31, 2005, and their results of operations, along with the results of operations of the 15 properties sold, are presented in discontinued operations.

Assets held for sale and liabilities related to assets held for sale in the accompanying Consolidated Balance Sheets include the following:

	December 31,	
	2005	2004
Real estate (net of accumulated depreciation of \$26,853 in 2005 and \$3,257 in 2004)	\$60,713	\$21,358
Other assets, net	2,808	512
	<u>\$63,521</u>	<u>\$21,870</u>
Notes and interest payable	\$52,641	\$20,529
Other liabilities	2,030	135
	<u>\$54,671</u>	<u>\$20,664</u>

The December 31, 2005, amounts include balances related to five apartment communities and nine commercial properties we either have under contract of sale or are actively marketing for sale. The December 31, 2004, amounts include balances related to an apartment community sold in January 2005.

In accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets," operating results for properties sold or for which we have implemented plans of disposal have been reported in discontinued operations. Discontinued operations for the years ended December 31, 2005, 2004 and 2003, include the operations of properties sold since the beginning of 2003 and 14 properties held for sale as of December 31, 2005, which were previously reported in the Investment Division. The results of these operations were as follows:

	For the Years Ended December 31,		
	2005	2004	2003
Rental revenue	\$ 26,431	\$ 38,078	\$ 39,803
Property operating expenses	(15,512)	(20,760)	(23,035)
Interest expense	(6,408)	(8,519)	(8,471)
Depreciation expense	(211)	(7,390)	(8,708)
Impairment charges	(1,438)	(400)	—
Income (loss) from operations before income taxes	2,862	1,009	(411)
Income tax expense	(1,089)	(599)	—
Income (loss) from operations	<u>\$ 1,773</u>	<u>\$ 410</u>	<u>\$ (411)</u>
Gain on sale of real estate before income taxes	67,326	17,988	23,118
Income tax expense	(25,617)	(7,038)	—
Gain on sale of real estate	<u>\$ 41,709</u>	<u>\$ 10,950</u>	<u>\$ 23,118</u>



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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 13. ASSETS HELD FOR SALE (Continued)

In 2005, we recorded a total of \$1.4 million in impairment charges to reduce the carrying value of four properties in our Investment Division after entering into contracts for sale, reducing their carrying value to equal the sales value. In 2004, we recorded an impairment charge of \$400,000 to the carrying value of a shopping center in our Investment Division after determining its value had been impaired.

NOTE 14. SEGMENT REPORTING

Our business is divided into two principal segments – homebuilding and the operation of our investment portfolio. Our Homebuilding Division is the main focus of our business in terms of financial and human capital. Our activities in the Homebuilding Division encompass condominium conversions of existing apartment communities, the development of town homes and new mid-rise or high-rise condominiums for sale to residents, land development and sale, and development of new rental properties, primarily apartment communities. Funds generated by the operation, sale, or refinancing of properties in the investment portfolio support our overhead and finance our homebuilding activities. As discussed in NOTE 13, “ASSETS HELD FOR SALE,” in March 2005, our board of directors approved a strategic plan to divest a substantial portion of our Investment Division properties. Pursuant to this plan, we sold 15 properties during 2005 and have 14 properties classified as held for sale at December 31, 2005.

Homebuilding. Our active for-sale communities at December 31, 2005, include the following:

Community	Location	Remaining Homes or Home Sites
High-and mid-rise developments:		
1100 Adams	Hoboken, NJ	76
900 Monroe (2)	Hoboken, NJ	125
Alta Mar	Ft. Meyers, FL	131(1)
Block 88	Hoboken, NJ	220
Block 99 (2)	Hoboken, NJ	217
The Exchange	Ft. Lauderdale, FL	87
Las Olas River House	Ft. Lauderdale, FL	40(1)
One Hudson Park	Edgewater, NJ	168
Trio	Palisades Park, NJ	196
XII Hundred Grand (2), (3)	Hoboken, NJ	—(1)
XIII Hundred Grand (2), (3)	Hoboken, NJ	—(1)
		1,260
Condominium and townhome conversions:		
210 Watermark	Bradenton, FL	216
5600 Collins Avenue	Miami Beach, FL	6
Bermuda Island	Naples, FL	360
Bishops Court at Windsor Parke	Jacksonville, FL	324
The Bordeaux	Orlando, FL	96
Central Park at Lee Vista	Orlando, FL	210
Georgetown at Celebration (3)	Celebration, FL	—
Cordoba Beach Park	Tampa, FL	97
The Grande (2)	Orlando, FL	1

The Hamptons (2)	Orlando, FL	102
Knightsbridge at Stoneybrooke	Orlando, FL	396
Lofts on Post Oak (2)	Houston, TX	316
Madison at Park West	Charleston, SC	244
Mirabella	Jacksonville, FL	400
Monterra at Bonita Springs	Bonita Springs, FL	244
Montreux at Deerwood Lake	Jacksonville, FL	237
Oxford Place	Tampa, FL	298

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 14. SEGMENT REPORTING (Continued)

Community	Location	Remaining Homes or Home Sites
Condominium and townhome conversions (continued):		
The Quarter at Ybor City	Ybor City, FL	247
Southampton Pointe	Mt. Pleasant, SC	146
The Tradition at Palm Aire	Sarasota, FL	248
Twelve Oaks at Fenwick Plantation	Charleston, SC	216
Via Lugano	Boynton Beach, FL	364
Vista Grande	Tampa, FL	378
Waterstreet at Celebration	Celebration, FL	1
Yacht Club on the Intracoastal	Hypoluxo, FL	3
		5,150
Townhome and traditional new developments:		
Orchid Grove (2)	Pompano Beach, FL	481
Venetian Bay Village III	Kissimmee, FL	2
The Villas at Seven Dwarfs Lane	Orlando, FL	256
Warwick Grove	Warwick, NY	196
		935
Land development:		
Alexandria Pointe	Deland, FL	84
Belle Park	Nashville, TN	21
Lincoln Pointe	Aventura, FL	460
Southridge Pointe	Deland, FL	18
Woods of Lake Helen	Lake Helen, FL	70
Woods at Southridge	Deland, FL	8
		661
		8,006

- (1) We have recognized revenue from the sale of 131 homes for Alta Mar and 251 homes for Las Olas River House (of which 247 units have been delivered), 159 and 118, respectively, for XII Hundred Grand and XIII Hundred Grand (all of which have been delivered) under the percentage-of-completion method as of December 31, 2005.
- (2) Unconsolidated property.
- (3) Although all residential units have been delivered to buyers, these projects are still categorized as active projects because they have unsold commercial spaces, garages, or storage units as of December 31, 2005.

Also included in the Homebuilding Division are rental communities under development or in initial lease-up and land held for development or sale. We had apartment communities with 860 units in lease-up and/or

under construction at December 31, 2005.

We measure the performance of our Homebuilding Division primarily by gross profit from home sales. In 2003, home sales included inter-divisional sales, which represents the transfer of properties between segments. The sale prices for these properties were their estimated fair market values as of the date of transfer, and the cost of sales was their net carrying values as of the same date. Gains on transfers of assets between segments do not represent gains recognizable in accordance with GAAP and, accordingly, are eliminated for purposes of consolidated reporting. In 2004, we began to transfer properties between divisions at cost, and we no longer report intercompany sales.

Investment. This division includes properties with stabilized operations. We consider a property stabilized when development or renovation is substantially complete and recurring operating income exceeds operating expenses and debt service. At December 31, 2005, our Investment Division had 2,733 consolidated stabilized apartments and 6,044 stabilized apartments owned through an unconsolidated partnership. It also had consolidated commercial properties with 884,000 square feet and one commercial property owned through an unconsolidated joint venture with 62,000 square feet. The results of operations of five consolidated apartment communities with 948 units and nine consolidated commercial properties with 782,000 square feet that are held for sale have been presented in discontinued operations in the accompanying Consolidated Statements of Income.

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 14. SEGMENT REPORTING (Continued)

We use net operating income to measure the performance of our Investment Division. Net operating income is defined as rental revenue less property operating expenses. We believe net operating income is an important supplemental measure of operating performance of our investment properties because it provides a measure of the core operations of the properties. Additionally, we believe that net operating income, as defined, is a widely accepted measure of comparative operating performance in the real estate investment community. We believe that net income is the most directly comparable GAAP measure to net operating income. The operating statements for the Investment Division present reconciliations of Investment Division net operating income to Investment Division income before taxes.

We allocate our general and administrative expenses between the segments based on the functions of the corporate departments. We allocate other corporate items, including interest income, management fee and other revenue, and minority interests in income of consolidated partnerships and joint ventures, that are not directly associated with one of our divisions in the same proportions as general and administrative expenses are allocated. Income tax expense and liabilities are not allocated between the divisions. Income tax liabilities totaled \$81 million at December 31, 2005, and \$14.2 million at December 31, 2004.

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 14. SEGMENT REPORTING (Continued)

Following are operating statements and balance sheets for our two divisions and net operating income for our Investment Division. In our segment operating statements, we do not distinguish between consolidated and unconsolidated properties. We have provided a reconciliation of segment revenue to consolidated revenue below.

	HOMEBUILDING DIVISION					
	Operating Statements					
	For the Years Ended December 31,					
	2005		2004		2003	
Homebuilding sales	\$ 735,528	100%	\$ 315,496	100%	\$ 298,571	100%
Cost of homebuilding sales (1)	(555,858)	(76%)	(240,960)	(76%)	(246,309)	(82%)
Gross profit on homebuilding sales	179,670	24%	74,536	24%	52,262	18%
Minority interests in homebuilding sales of consolidated partnerships and joint ventures	(2,093)	—	(2,822)	(1%)	(409)	—
Outside partners' interests in homebuilding sales of unconsolidated partnerships and joint ventures	(34,436)	(5%)	(14,664)	(5%)	(3,887)	(1%)
Outside partners' interest in intercompany sales of unconsolidated partnerships and joint ventures	—	—	—	—	(3,988)	(1%)
Overhead costs associated with investment in joint ventures	(1,404)	—	—	—	—	—
Performance-based compensation related to projects of	(2,757)	—	—	—	—	—



unconsolidated partnerships and joint ventures						
Additional costs attributable to profits recognized by the investment division on intercompany sales	(2,363)	—	(6,701)	(2%)	(5,640)	(2%)
	<u>136,617</u>	<u>19%</u>	<u>50,349</u>	<u>16%</u>	<u>38,338</u>	<u>14%</u>
Other income and expenses:						
Net income (loss) from rental operations	794	—	(2,027)	(1%)	(6,069)	(2%)
Mortgage banking net income	457	—	—	—	—	—
General and administrative expenses	(16,229)	(2%)	(14,341)	(5%)	(11,500)	(4%)
Other corporate items	550	—	1,289	—	1,896	1%
Prepayment penalty on early retirement of debt in connection with condominium conversion	—	—	—	—	(3,117)	(1%)
Impairment charges	—	—	(733)	—	(313)	—
Gain on sale of real estate or disposition of other assets	1,979	—	2,048	1%	—	—
Provision for loss contingency	(1,000)	—	—	—	—	—
Income before taxes	<u>\$ 123,168</u>	<u>17%</u>	<u>\$ 36,585</u>	<u>11%</u>	<u>\$ 19,235</u>	<u>8%</u>

- (1) Cost of homebuilding sales includes marketing and advertising of for-sale communities, salaries and office costs related to personnel directly involved in acquiring, managing, and accounting for for-sale communities, as well as land, construction costs, architectural and engineering fees, and capitalized interest.



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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 14. SEGMENT REPORTING (Continued)

	HOMEBUILDING DIVISION Balance Sheets December 31,	
	2005	2004
<b>Assets</b>		
Homebuilding inventory (1)	\$1,079,811	\$287,873
Real estate held for investment	71,022	42,446
Contracts receivable	49,745	99,744
Investments in partnerships and joint ventures	79,173	44,217
Cash and cash equivalents	36,638	20,136
Restricted cash	18,846	23,757
Other assets	56,745	29,600
	<u>\$1,391,980</u>	<u>\$547,773</u>
<b>Liabilities and Equity</b>		
Notes and interest payable	\$ 768,345	\$237,358
Other liabilities	78,416	55,997
	<u>846,761</u>	<u>293,355</u>
Minority interest	3,309	11,259
Equity	541,910	243,159
	<u>\$1,391,980</u>	<u>\$547,773</u>

- (1) Prior to 2004, the Homebuilding Division recognized profits on properties it transferred to the Investment Division upon completion and stabilization. In 2004, we began to transfer properties between divisions at cost. In 2005, nine properties were transferred from the Investment Division to the Homebuilding Division for conversion and sale as condominium homes. Homebuilding inventory of the Homebuilding Division includes \$24.7 million of additional basis as of December 31, 2005 and \$519,000 as of December 31, 2004 related to these profits from transfers prior to 2004.

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 14. SEGMENT REPORTING (Continued)

	INVESTMENT DIVISION Operating Statements For the Years Ended December 31,					
	2005		2004		2003	
Rental revenue	\$114,870	100%	\$135,605	100%	\$124,174	100%
Property operating expenses	(60,664)	(53%)	(70,106)	(52%)	(65,185)	(52%)
Net operating income	54,206	47%	65,499	48%	58,989	48%
Net gain on sale of real estate	63,971		20,592		21,384	
Distributions from unconsolidated partnerships and joint ventures in excess of investment	65,043		6,529		9,819	
Deferred equity in (income) loss of unconsolidated partnerships and joint ventures	15,266		(724)		(699)	
Minority interests in income of consolidated partnerships and joint ventures	(178)		(847)		(1,770)	
Elimination of management and other fees paid to Tarragon by unconsolidated partnerships and joint ventures	1,473		1,456		1,525	
Outside partners' interests in (income) losses of unconsolidated partnerships and joint ventures	1,628		(576)		614	
General and administrative expenses (including investment banking advisory	(9,858)		(6,425)		(5,426)	

fees of \$2,375 for the year ended December 31, 2005)			
Other corporate items	1,175	644	693
Impairment charges	(3,066)	(1,812)	—
Loss on early extinguishment of debt	(9,354)	—	—
Litigation settlement	(214)	—	—
Interest expense (including \$7,153 of interest and premium associated with the conversion of convertible debt for the year ended December 31, 2005 and includes \$16,954 of prepayment penalties and the write-off of deferred borrowing costs in connection with Ansonia's November 2005 refinance of 23 properties)	(57,911)	(39,784)	(36,422)
Depreciation expense	(18,877)	(31,074)	(29,884)
Income before taxes	<u>\$103,304</u>	<u>\$ 13,478</u>	<u>\$ 18,823</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)NOTE 14. SEGMENT REPORTING (Continued)

	INVESTMENT DIVISION Balance Sheets December 31,	
	2005	2004
<b>Assets</b>		
Real estate held for investment (1)	\$ 53,749	\$487,173
Assets held for sale (1)	71,100	21,870
Investments in partnerships and joint ventures	26,250	36,961
Cash and cash equivalents	1,989	1,930
Restricted cash	2,984	6,453
Other assets	5,979	17,469
	<u>\$162,051</u>	<u>\$571,856</u>
<b>Liabilities and Deficit</b>		
Notes and interest payable	\$137,982	\$532,889
Liabilities related to assets held for sale	54,670	20,664
Other liabilities	10,213	13,693
	<u>202,865</u>	<u>567,246</u>
Minority interest	11,094	14,489
Deficit (2)	<u>(51,908)</u>	<u>(9,879)</u>
	<u>\$162,051</u>	<u>\$571,856</u>

- (1) Prior to 2004, the Homebuilding Division recognized profits on properties it transferred to the Investment Division upon completion and stabilization. In 2004, we began to transfer properties between divisions at cost. Real estate held for investment includes \$2.6 million of additional basis as of December 31, 2005, and \$40.4 million as of December 31, 2004 related to these profits from transfers prior to 2004. Assets held for sale include \$7.6 million of additional basis as of December 31, 2005 related to these profits from transfers prior to 2004.
- (2) The Investment Division's deficit is the result of distributions to the parent company exceeding accumulated divisional earnings.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)NOTE 14. SEGMENT REPORTING (Continued)

	For the Years Ended December 31,					
	2005		2004		2003	
<b>Investment division net operating income:</b>						
Rental revenue						
Same store stabilized apartment communities	\$ 65,675	100%	\$ 63,772	100%	\$ 63,034	100%
Apartment communities stabilized during period	4,580	100%	4,717	100%	1,520	100%
Apartment communities targeted for condominium conversion in 2005	14,726	100%	26,907	100%	21,449	100%
Apartment communities acquired during period	5,697	100%	1,017	100%	—	—
Apartment communities targeted for reposition in 2003	1,602	100%	1,153	100%	1,282	100%
Apartment communities sold during period	8,502	100%	22,280	100%	22,555	100%
Commercial properties	14,088	100%	15,759	100%	14,334	100%
	<u>114,870</u>	<u>100%</u>	<u>135,605</u>	<u>100%</u>	<u>124,174</u>	<u>100%</u>
Property operating expenses						
Same store stabilized apartment communities	(33,969)	(52%)	(33,178)	(52%)	(33,312)	(53%)

Apartment communities stabilized during period	(1,704)	(37%)	(1,842)	(39%)	(706)	(46%)
Apartment communities targeted for condominium conversion in 2005	(7,076)	(48%)	(12,385)	(46%)	(10,412)	(49%)
Apartment communities acquired during period	(3,396)	(60%)	(674)	(66%)	—	—
Apartment communities targeted for reposition in 2003	(1,176)	(73%)	(1,020)	(88%)	(1,113)	(87%)
Apartment communities sold during period	(5,830)	(69%)	(13,006)	(58%)	(12,906)	(57%)
Commercial properties	(7,513)	(53%)	(8,001)	(51%)	(6,736)	(47%)
	(60,664)	(53%)	(70,106)	(52%)	(65,185)	(52%)
Net operating income						
Same store stabilized apartment communities	31,706	48%	30,594	48%	29,722	47%
Apartment communities stabilized during period	2,876	63%	2,875	61%	814	54%
Apartment communities targeted for condominium conversion in 2005	7,650	52%	14,522	54%	11,037	51%
Apartment communities acquired during period	2,301	40%	343	34%	—	—
Apartment communities targeted for reposition in 2003	426	27%	133	12%	169	13%



Apartment communities sold during period	2,672	31%	9,274	42%	9,649	43%
Commercial properties	6,575	47%	7,758	49%	7,598	53%
	<u>\$ 54,206</u>	<u>47%</u>	<u>\$ 65,499</u>	<u>48%</u>	<u>\$ 58,989</u>	<u>48%</u>

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 14. SEGMENT REPORTING (Continued)

	For the Years Ended December 31,		
	2005	2004	2003
<b>Reconciliation of divisional revenues to consolidated revenue:</b>			
Homebuilding division total revenue	\$ 735,528	\$315,496	\$ 298,571
Less homebuilding revenue from intercompany sales	—	—	(144,709)
Less homebuilding sales revenue of unconsolidated partnerships and joint ventures	(230,806)	(95,031)	(97,583)
Add management fee and other revenue included in other corporate items	278	633	724
Add rental revenue from homebuilding properties presented in net income (loss) from rental operations (1)	13,767	1,625	11,149
Less rental revenue of unconsolidated partnerships and joint ventures	—	(6)	(4,626)
Homebuilding division contribution to consolidated revenue	<u>518,767</u>	<u>222,717</u>	<u>63,526</u>
Investment division rental revenue	114,870	135,605	124,174
Less investment division rental revenue presented in discontinued operations	(26,431)	(38,078)	(39,803)
Add management fee and other revenue included in other corporate items	451	194	197
Less rental revenue of unconsolidated partnerships and joint ventures	(35,723)	(37,574)	(42,908)
Investment division contribution to consolidated revenue	<u>53,167</u>	<u>60,147</u>	<u>41,660</u>
Consolidated total revenue	<u>\$ 571,934</u>	<u>\$282,864</u>	<u>\$ 105,186</u>
<b>Reconciliation of divisional net income to consolidated net income:</b>			
Homebuilding division net income before taxes	\$ 123,168	\$ 36,585	\$ 19,235
Less homebuilding division profit from intercompany sales	—	—	(18,225)
Add additional costs attributable to profits recognized by investment division on intercompany sales (2)	2,363	6,701	5,640
Add depreciation on higher basis resulting from intercompany sales	—	30	104
Homebuilding division contribution to consolidated net income	<u>125,531</u>	<u>43,316</u>	<u>6,754</u>
Investment division income before taxes	103,304	13,478	18,823
Less investment division gain on intercompany sales	—	—	(2,885)
Add reduction to investment division gain on sale of real estate for profit previously recognized by homebuilding division (3)	4,885	—	5,844
Add depreciation on higher basis resulting from intercompany sales (3)	<u>1,615</u>	<u>2,949</u>	<u>2,658</u>

Investment division contribution to consolidated net income	<u>109,804</u>	<u>16,427</u>	<u>24,440</u>
Income tax expense	<u>(89,544)</u>	<u>(15,035)</u>	<u>—</u>
Consolidated net income	<u>\$ 145,791</u>	<u>\$ 44,708</u>	<u>\$ 31,194</u>

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- (1) Rental revenue generated by properties transferred from the Investment Division to the Homebuilding Division for conversion to condominiums and properties developed by the Homebuilding Division in lease-up.
- (2) Prior to 2004, the Investment Division recognized gains on transfers of properties to the Homebuilding Division for conversion and sale as condominium homes. Beginning in 2004, properties are transferred between divisions at cost.
- (3) Prior to 2004, the Homebuilding Division recognized profits on properties it transferred to the Investment Division upon completion and stabilization. Beginning in 2004, properties are transferred between divisions at cost.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)NOTE 14. SEGMENT REPORTING (Continued)

	December 31,	
	2005	2004
<b>Reconciliation of divisional total assets to consolidated total assets:</b>		
Homebuilding division total assets	\$1,391,980	\$ 547,773
Investment division total assets	162,051	571,856
	<u>1,554,031</u>	<u>1,119,629</u>
Less higher basis resulting from intercompany sales (1)	(61,178)	(74,029)
Add goodwill	<u>2,691</u>	<u>2,691</u>
Consolidated total assets	<u>\$1,495,544</u>	<u>\$1,048,291</u>

(1) Prior to 2004, both divisions recognized gains on transfers of properties between divisions. Beginning in 2004, properties are transferred between divisions at cost.

NOTE 15. QUARTERLY RESULTS OF OPERATIONS

The following is a tabulation of the quarterly results of operations for the years ended December 31, 2005 and 2004 (unaudited). The quarterly results of operations have been restated to present the operating results of 20 properties sold in 2005 and 2004 and 14 properties held for sale at December 31, 2005, in discontinued operations in accordance with SFAS No. 144. In the fourth quarter of 2004, we made an adjustment to deferred tax liabilities, which increased income tax expense by approximately \$2.1 million.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2005				
Revenue	\$ 80,744	\$ 86,513	\$ 261,026	\$ 143,651
Expenses	(66,274)	(75,654)	(213,449)	(112,274)
Other income and expenses:				
Equity in income of partnerships and joint ventures	8,430	8,239	10,819	69,807
Minority interests in income of consolidated partnerships and joint ventures	(836)	(509)	(652)	(567)
Interest income	142	157	219	477
Interest expense	(5,439)	(5,499)	(12,438)	(4,425)
Gain on sale of real estate	2,229	342	50	1,187
Loss on disposition of other assets	—	—	(300)	—
Loss on early extinguishment of debt	—	—	—	(9,354)
Litigation, settlements, and other claims	—	—	—	(1,214)
Income from continuing operations before income taxes	<u>18,996</u>	<u>13,589</u>	<u>45,275</u>	<u>87,288</u>
Income tax expense	<u>(7,348)</u>	<u>(5,166)</u>	<u>(17,106)</u>	<u>(33,219)</u>
Income from continuing operations	<u>11,648</u>	<u>8,423</u>	<u>28,169</u>	<u>54,069</u>
Discontinued operations, net of income taxes				
Income (loss) from operations	972	636	(152)	317

Gain on sale of real estate	<u>8,986</u>	<u>—</u>	<u>22,437</u>	<u>10,285</u>
Net income	<u>21,606</u>	<u>9,059</u>	<u>50,454</u>	<u>64,671</u>
Dividends on cumulative preferred stock	<u>(224)</u>	<u>(225)</u>	<u>(225)</u>	<u>(225)</u>
Net income allocable to common stockholders	<u>\$ 21,382</u>	<u>\$ 8,834</u>	<u>\$ 50,229</u>	<u>\$ 64,446</u>

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TARRAGON CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 15. QUARTERLY RESULTS OF OPERATIONS (Continued)

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
2005				
Earnings per common share — basic				
Income from continuing operations allocable to common stockholders	\$ .48	\$ .34	\$ 1.06	\$ 1.87
Discontinued operations	.42	.03	.85	.37
Net income allocable to common stockholders	<u>\$ .90</u>	<u>\$ .37</u>	<u>\$ 1.91</u>	<u>\$ 2.24</u>
Earnings per common share — assuming dilution				
Income from continuing operations allocable to common stockholders	\$ .39	\$ .28	\$ 1.01	\$ 1.68
Discontinued operations	.31	.02	.69	.33
Net income allocable to common stockholders	<u>\$ .70</u>	<u>\$ .30</u>	<u>\$ 1.70</u>	<u>\$ 2.01</u>
2004				
Revenue	\$ 51,459	\$ 57,621	\$ 72,398	\$ 101,386
Expenses	(45,950)	(48,865)	(60,972)	(87,599)
Other income and expenses:				
Equity in income (loss) of partnerships and joint ventures	787	5,023	(97)	15,817
Minority interests in (income) loss of consolidated partnerships and joint ventures	(1,603)	(1,886)	(397)	68
Interest income	326	87	164	151
Interest expense	(4,221)	(4,318)	(4,646)	(6,188)
Gain on sale of real estate	378	—	—	—
Gain on disposition of other assets	377	1,698	—	—
Litigation, settlements, and other claims	—	—	—	(250)
Income from continuing operations before income taxes	1,553	9,360	6,450	23,385
Income tax (expense) benefit	—	5,032	(2,632)	(9,800)
Income from continuing operations	1,553	14,392	3,818	13,585
Discontinued operations, net of income taxes				
Income (loss) from operations	392	117	76	(175)
Gain on sale of real estate	—	2,666	—	8,284
Net income	1,945	17,175	3,894	21,694
Dividends on cumulative preferred stock	(226)	(226)	(226)	(226)
Net income allocable to common stockholders	<u>\$ 1,719</u>	<u>\$ 16,949</u>	<u>\$ 3,668</u>	<u>\$ 21,468</u>
Earnings per common share — basic				
Income from continuing operations allocable to common stockholders	\$ .06	\$ .63	\$ .16	\$ .58

Discontinued operations	<u>.02</u>	<u>.12</u>	<u>—</u>	<u>.35</u>
Net income allocable to common stockholders	<u>\$ .08</u>	<u>\$ .75</u>	<u>\$ .16</u>	<u>\$ .93</u>
Earnings per common share – assuming dilution				
Income from continuing operations allocable to common stockholders	\$ .05	\$ .55	\$ .14	\$ .46
Discontinued operations	<u>.02</u>	<u>.11</u>	<u>—</u>	<u>.26</u>
Net income allocable to common stockholders	<u>\$ .07</u>	<u>\$ .66</u>	<u>\$ .14</u>	<u>\$ .72</u>

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and  
Stockholders of Tarragon Corporation

In connection with our audits of the consolidated financial statements of Tarragon Corporation and Subsidiaries referred to in our report dated March 15, 2006, which is included in Part IV of this Form 10-K, we have also audited Schedules II and III for each of the three years in the period ended December 31, 2005. In our opinion, these schedules present fairly, in all material respects in relation to the financial statements taken as a whole, the information required to be set forth therein.

/s/ GRANT THORNTON LLP

Dallas, Texas  
March 15, 2006